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MAR 23 2012

Washington, DC 20549

# Severn Bancorp, Inc.

## 2011 Annual Report

## Dear Severn Bancorp, Inc. Shareholders:

While there seems to be signs of improvement in the economy, particularly in certain pockets and industries, business continues to be challenging. Despite the continuing challenging economy, our company had net income of \$1,219,000 for 2011, compared to \$1,157,000 for 2010. That resulted in a loss of \$.05 per share in 2011, compared to a loss of \$.06 per share for 2010, after payment of preferred stock dividends.



One thing has become very apparent as we have labored our way through the tough economic situation – we can not wait for things to return to normal. Things will not return to the way they were and Severn is busily adapting. The economy has certainly changed and so, too, has the banking industry, customers and technology. This is a lot to keep up with but is something we must do to not only survive, but to succeed. We have a plan to combine the right strategy, team and technology to position Severn as the bank of choice for residents and businesses of Anne Arundel County. All of this must be done under much more scrutiny and reporting requirements by our regulators. I am writing to let you know we are up to that task.

We made several changes in 2011 from which we are now realizing some of the benefits. We formed an E-Home finance department that generates business based on internet leads to capitalize on the low mortgage rate environment. We have also fortified our community mortgage lending division with mortgage experts dedicated to exceptional customer service. We have a first-rate commercial banking team of professionals representing us in the community. Our organization as a whole is dedicated to unmatched personal service. All of these efforts by our staff have merged with our transition to new technologies being demanded by consumers. Our efforts to operate as efficiently as possible should result in a company that will be a viable community banking organization.

Much of what will be expected by our customers must be transparent to them. What will ultimately make a difference to our current and potential customers will be results. We need to deliver excellent service and provide a full complement of products relevant to our market place. That is the true underpinning of our relationship banking message, and that is what can help Severn stand out above all of the others. We are excited to share our message with shareholders and with customers. We hope you will have the chance to experience the Severn difference in some way this coming year, and we hope we can count on your continued support.

Sincerely,

A handwritten signature in dark ink, appearing to be 'A. Hyatt'.

**Alan J. Hyatt**  
President



**It's safe here.**

## Severn Bancorp, Inc. Financial Highlights

(dollars in thousands, except per share data)

	2011	2010	2009	2008	2007
Balance Sheet Data:					
Total assets	<b>\$900,628</b>	\$962,543	\$967,788	\$987,651	\$962,234
Total loans, net	<b>697,431</b>	782,363	819,079	896,459	893,014
Total nonperforming assets	<b>51,364</b>	67,119	82,382	61,112	10,693
Deposits	<b>652,757</b>	714,776	710,329	683,866	652,773
Stockholders' equity	<b>105,930</b>	106,100	106,231	123,667	95,276
Net income (loss)	<b>1,219</b>	1,157	(15,228)	4,113	11,111

### Per Share Data \*

Earnings (loss) per common share:

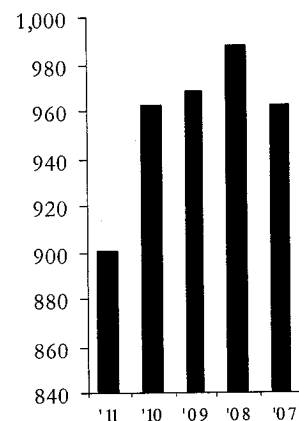
Basic	<b>\$(0.05)</b>	\$(0.06)	\$(1.68)	\$0.39	\$1.10
Diluted	<b>(0.05)</b>	(0.06)	(1.68)	0.39	1.10
Book value	<b>7.88</b>	7.89	7.91	9.64	9.46
Common stock cash dividends	-	-	0.09	0.24	0.24

### Performance ratios:

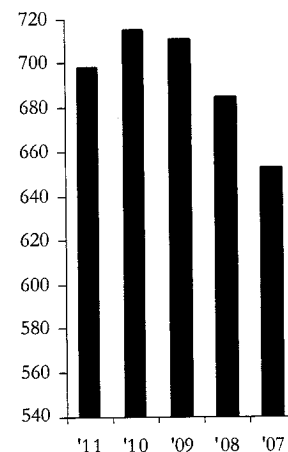
Return on average assets	<b>0.13%</b>	0.12%	(1.54%)	0.43%	1.19%
Return on average equity	<b>1.15%</b>	1.12%	(13.13%)	4.03%	12.09%
Efficiency ratio	<b>61.11%</b>	59.15%	61.77%	51.64%	42.82%

\*retroactively adjusted to reflect 10% stock dividend declared February 20, 2007.

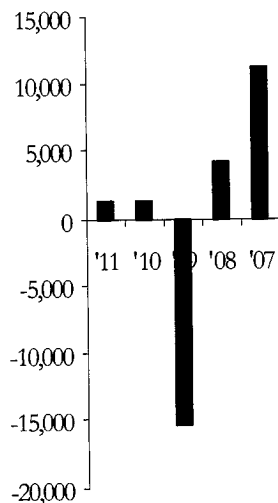
TOTAL ASSETS  
(\$ IN MILLIONS)



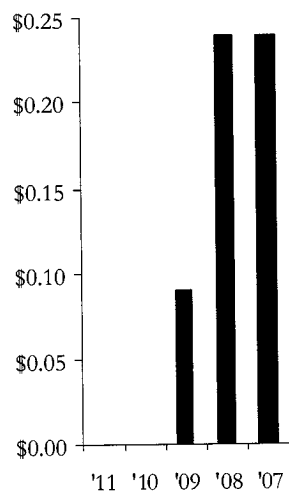
DEPOSITS  
(\$ IN MILLIONS)



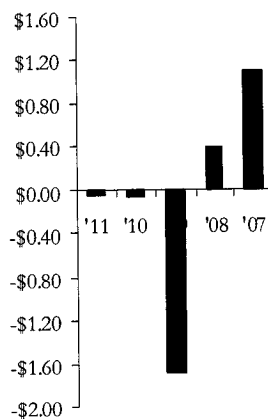
NET INCOME (LOSS)  
(\$ IN THOUSANDS)



ANNUAL DIVIDEND  
PER SHARE



DILUTED  
EARNINGS  
(LOSS) PER SHARE



## Severn Bancorp, Inc. Financial Highlights

(dollars in thousands, except per share information)

	As of December 31,				
	2011	2010	2009	2008	2007
<b>Balance Sheet Data:</b>					
Total assets	<b>\$900,628</b>	\$962,543	\$967,788	\$987,651	\$962,234
Total loans, net (including loans held for sale)	<b>697,431</b>	782,363	819,079	896,459	893,014
Total non-performing assets	<b>51,364</b>	67,119	82,382	61,112	10,693
Deposits	<b>652,757</b>	714,776	710,329	683,866	652,773
Short-term borrowings	-	-	-	-	15,000
Long-term borrowings	<b>115,000</b>	115,000	125,000	153,000	175,000
Subordinated debentures	<b>24,119</b>	24,119	24,119	24,119	20,619
Stockholders' equity	<b>105,930</b>	106,100	106,231	123,667	95,276
Book value per share*	<b>7.88</b>	7.89	7.91	9.64	9.46
<b>Operations Data:</b>					
	For the Year Ended December 31,				
	2011	2010	2009	2008	2007
Net interest income	<b>\$28,914</b>	\$30,204	\$26,607	\$28,969	\$33,638
Net interest income (loss) after provision for loan losses	<b>24,302</b>	24,460	(4,795)	21,488	31,176
Non-interest income	<b>2,510</b>	2,745	2,501	2,791	4,336
Non-interest expense	<b>24,611</b>	25,008	22,862	17,293	16,492
Net income (loss)	<b>1,219</b>	1,157	(15,228)	4,113	11,111
Basic earnings (loss) per share *	<b>(0.05)</b>	(0.06)	(1.68)	0.39	1.10
Diluted earnings (loss) per share *	<b>(0.05)</b>	(0.06)	(1.68)	0.39	1.10
Common Stock Cash dividends declared per share*	-	-	0.09	0.24	0.24
Common Stock dividends declared per share to diluted earnings per share *	-	-	(5.36%)	61.54%	21.82%
Weighted number of shares outstanding basic *	<b>10,066,679</b>	10,066,679	10,066,679	10,066,679	10,066,283
Weighted number of shares outstanding diluted *	<b>10,066,679</b>	10,066,679	10,066,679	10,066,679	10,066,283
<b>Performance Ratios:</b>					
Return on average assets	<b>0.13%</b>	0.12%	(1.54%)	0.43%	1.19%
Return on average equity	<b>1.15%</b>	1.12%	(13.13%)	4.03%	12.09%
Interest rate spread	<b>3.34%</b>	3.36%	2.64%	2.81%	3.45%
Net interest margin	<b>3.39%</b>	3.40%	2.90%	3.16%	3.81%
Non-interest expense to average assets	<b>2.62%</b>	2.56%	2.32%	1.79%	1.76%
Efficiency ratio	<b>61.11%</b>	59.15%	61.77%	51.64%	42.82%

\* Retroactively adjusted to reflect 10% stock dividend declared February 20, 2007.



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

SEC  
Mail Processing  
Section

MAR 23 2012

FORM 10-K

Washington, DC

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2011

or

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-49731

SEVERN BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of incorporation or organization)

52-1726127

(I.R.S. Employer Identification Number)

200 Westgate Circle, Suite 200, Annapolis,

Maryland

(Address of principal executive offices)

21401

(Zip Code)

Registrant's telephone number, including area code: (410) 260-2000

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of each exchange on which registered

Common Stock, par value \$.01 per share

Nasdaq Capital Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes ☐ No ☒

**Note** - Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☒

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated filer ☐  
Smaller reporting company ☒

Non-accelerated filer ☐ (Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒

The aggregate market value of the 5,395,762 shares of common stock held by non-affiliates of the registrant, based on the closing sale price of the registrant's common stock on June 30, 2011 of \$3.24 per share was \$17,482,269.

#### (APPLICABLE ONLY TO CORPORATE REGISTRANTS)

Indicate the number of shares outstanding for each of the registrant's classes of common stock, as of the latest practicable date.

As of March 1, 2012, there were issued and outstanding 10,066,679 shares of the registrant's common stock.

#### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Definitive Proxy Statement for its 2012 Annual Meeting of Stockholders, which Definitive Proxy Statement will be filed with the Securities and Exchange Commission no later than 120 days after the registrant's fiscal year-ended December 31, 2011, are incorporated by reference into Part III of this Form 10-K; provided, however, that the Compensation Committee Report, the Audit Committee Report and any other information in such proxy statement that is not required to be included in this Annual Report on Form 10-K, shall not be deemed to be incorporated herein by reference or filed as a part of this Annual Report on Form 10-K.

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## **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

Severn Bancorp, Inc. ("Bancorp") may from time to time make written or oral "forward-looking statements", (as defined in the Securities Exchange Act of 1934, as amended, and the regulations thereunder) including statements contained in Bancorp's filings with the Securities and Exchange Commission (including this Annual Report on Form 10-K and the exhibits thereto), in its reports to stockholders and in other communications by Bancorp, pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements include, but are not limited to:

- Statements contained in "Item 1A. Risk Factors;"
- Statements contained in "Business" concerning strategy, competitive strengths, liquidity and business plans;
- Statements contained in "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the notes to Bancorp's consolidated financial statements, such as statements concerning allowance for loan losses, liquidity, capital adequacy requirements, unrealized losses, guarantees, the Bank being well-capitalized, and impact of accounting pronouncements; and
- Statements as to trends or Bancorp's or management's beliefs, expectations and opinions.

The words "anticipate," "believe," "estimate," "expect," "intend," "may," "plan," "will," "would," "could," "should," "guidance," "potential," "continue," "project," "forecast," "confident," and similar expressions are typically used to identify forward-looking statements. These statements are based on assumptions and assessments made by management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. Any forward-looking statements are not guarantees of Bancorp's future performance and are subject to risks and uncertainties and may be affected by various factors that may cause actual results, developments and business decisions to differ materially from those in the forward-looking statements. Some of the factors that may cause actual results, developments and business decisions to differ materially from those contemplated by such forward-looking statements include the risk factors discussed under "Item 1A. Risk Factors" and the following:

- Changes in general economic and political conditions and by governmental monetary and fiscal policies;
- Changes in the economic conditions of the geographic areas in which Bancorp conducts business;
- Changes in interest rates;
- A downturn in the real estate markets in which Bancorp conducts business;
- The high degree of risk exhibited by Bancorp's loan portfolio;
- Environmental liabilities with respect to properties Bancorp has title;
- Changes in federal and state regulation;
- The effects of the supervisory agreements entered into by each of Bancorp and Severn Savings Bank, FSB with their respective federal regulator;
- Bancorp's ability to estimate loan losses;
- Competition;
- Breaches in security or interruptions in Bancorp's information systems, including cyber security risks;
- Bancorp's ability to timely develop and implement technology;

- Bancorp's ability to retain its management team;
- Perception of Bancorp in the marketplace;
- Bancorp's ability to maintain effective internal controls over financial reporting and disclosure controls and procedures; and
- Terrorist attacks and threats or actual war.

Bancorp can give no assurance that any of the events anticipated by the forward-looking statements will occur or, if any of them does, what impact they will have on Bancorp's results of operations and financial condition. Bancorp disclaims any intent or obligation to publicly update or revise any forward-looking statements, regardless of whether new information becomes available, future developments occur or otherwise.

## **PART I**

### **Item 1. Business**

#### **General**

Bancorp is a savings and loan holding company chartered as a corporation in the state of Maryland in 1990. It conducts business primarily through two subsidiaries, Severn Savings Bank, FSB ("Bank") and SBI Mortgage Company ("SBI"). The Bank's principal subsidiary Louis Hyatt, Inc. ("Hyatt Commercial"), conducts business as Hyatt Commercial, a commercial real estate brokerage and property management company. SBI holds mortgages that do not meet the underwriting criteria of the Bank, and is the parent company of Crownsville Development Corporation ("Crownsville"), which is doing business as Annapolis Equity Group, which acquires real estate for syndication and investment purposes.

The Bank has four branches in Anne Arundel County, Maryland, which offer a full range of deposit products, and originate mortgages in its primary market of Anne Arundel County, Maryland and, to a lesser extent, in other parts of Maryland, Delaware and Virginia.

On December 17, 2004, Bancorp acquired all the common stock of newly formed Severn Capital Trust I, a Delaware business trust. Severn Capital Trust I issued \$20,000,000 of trust preferred securities in a private placement pursuant to an applicable exemption from registration under the Securities Act of 1933, as amended. Bancorp irrevocably and unconditionally guaranteed the trust preferred securities. The proceeds of the trust preferred securities were used to purchase Bancorp's Junior Subordinated Debt Securities due 2035 (the "2035 Debentures").

On November 15, 2008, Bancorp sold a total of 70 units, at an offering price of \$100,000 per unit, for gross proceeds of \$7.0 million pursuant to a private placement exempt from registration under the Securities Act of 1933. Each unit consisted of 6,250 shares of Bancorp's Series A 8.0% Non-Cumulative Convertible Preferred Stock ("Series A Preferred Stock") and Bancorp's Subordinated Notes in the original principal amount of \$50,000 ("Subordinated Notes"). In the private placement, Bancorp issued a total of 437,500 shares of its Series A Preferred Stock and \$3.5 million aggregate principal amount of its Subordinated Notes.

The Emergency Economic Stabilization Act of 2008 ("EESA") authorized the U.S. Department of the Treasury ("Treasury Department") to purchase from financial institutions and their holding companies up to \$700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies in the Troubled Asset Relief Program ("TARP"). The Treasury Department allocated \$250 billion towards the TARP Capital Purchase Program ("CPP"). Under the CPP, Treasury purchased debt or equity securities from participating institutions. Bancorp made application to the Treasury Department to participate in this program. On November 21, 2008, Bancorp entered into a Letter Agreement (the "Purchase Agreement") with the Treasury Department, pursuant to which Bancorp issued and sold (i) 23,393 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$0.01 per share and liquidation preference \$1,000 per share, (the "Series B Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 556,976 shares of Bancorp's common stock at \$6.30 per (the "Common Stock"), for an aggregate purchase price of \$ 23,393,000 in cash. Closing of the sale occurred on November 21, 2008.

On November 23, 2009, Bancorp and the Bank each entered into a supervisory agreement with the Office of Thrift Supervision ("OTS") which primarily addressed issues identified in the OTS' reports of examination of Bancorp's and the Bank's operations and financial condition conducted in 2009. The Bank's supervisory agreement is now enforced by the Office of the Comptroller of the Currency. Bancorp's supervisory agreement is now enforced by the Federal Reserve. See "Supervisory Agreements" for more information.

Until recently, Bancorp and the Bank were regulated by the OTS. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the OTS was eliminated and, as of July 21, 2011, the regulatory oversight functions and authority of the OTS related to the Bank were transferred to the Office of the Comptroller of the

Currency (the “OCC”) and the regulatory oversight functions and authority of the OTS related to Bancorp were transferred to the Board of Governors of the Federal Reserve System (the “Federal Reserve”). See “Regulation – Regulatory Reform and Legislation.”

As of December 31, 2011, Bancorp had total assets of \$900,628,000, total deposits of \$652,757,000, and total stockholders’ equity of \$105,930,000. Net income of Bancorp for the year ended December 31, 2011 was \$1,219,000. For more information, see “Item 6. Selected Financial Data.”

Bancorp’s internet address is [www.severnbank.com](http://www.severnbank.com). Bancorp makes available free of charge on [www.severnbank.com](http://www.severnbank.com) its annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the SEC.

In addition, we will provide, at no cost, paper or electronic copies of our reports and other filings made with the SEC. Requests should be directed to:

Thomas G. Bevivino  
Executive Vice President  
Severn Bancorp, Inc.  
200 Westgate Circle, Suite 200  
Annapolis, Maryland 21401

The information on the website listed above, is not and should not be considered part of this Annual Report on Form 10-K and is not incorporated by reference in this document. This website is and is only intended to be an inactive textual reference.

## **Business of the Bank**

The Bank was organized in 1946 in Baltimore, Maryland as Pompei Permanent Building and Loan Association. It relocated to Annapolis, Maryland in 1980 and its name was changed to Severn Savings Association. Subsequently, the Bank obtained a federal charter and changed its name to Severn Savings Bank, FSB. The Bank operates four full-service branch offices, and one administrative office. The Bank operates as a federally chartered savings bank whose principal business is attracting deposits from the general public and investing those funds in mortgage and commercial loans. The Bank also uses advances, or loans, from the Federal Home Loan Bank of Atlanta, ("FHLB-Atlanta") to fund its mortgage activities. The Bank provides a wide range of retail and mortgage banking services. Deposit services include checking, savings, money market, time deposit and individual retirement accounts. Loan services include various types of real estate, consumer, and commercial lending. The Bank also provides safe deposit boxes, ATMs, debit cards, and internet and telephone banking.

The Bank's revenues are derived principally from interest earned on mortgage, commercial and other loans, and fees charged in connection with the loans and banking services. The Bank's primary sources of funds are deposits, advances from the FHLB-Atlanta, principal amortization and prepayment of its loans. The principal executive offices of the Bank are maintained at 200 Westgate Circle, Suite 200, Annapolis Maryland, 21401. Its telephone number is 410-260-2000 and its e-mail address is [mailman@severnbank.com](mailto:mailman@severnbank.com).

## **The Thrift Industry**

Thrift institutions are financial intermediaries which historically have accepted savings deposits from the general public and, to a lesser extent, borrowed funds from outside sources and invested those deposits and funds primarily in loans secured by first mortgage liens on residential and other types of real estate. Such institutions may also invest their funds in various types of short- and long-term securities. The deposits of bank and thrift institutions are insured by the Deposit Insurance Fund ("DIF") as administered by the Federal Deposit Insurance Corporation ("FDIC"), and these institutions are subject to extensive regulations. These regulations govern, among other things, the lending and other investment powers of thrift institutions, including the terms of mortgage instruments these institutions are permitted to utilize, the types of deposits they are permitted to accept, and reserve requirements.

The operations of thrift institutions, including those of the Bank, are significantly affected by general economic conditions and by related monetary and fiscal policies of the federal government and regulations and policies of financial institution regulatory authorities, including the Federal Reserve and the OCC into which the former Office of Thrift Supervision ("OTS") was merged. Lending activities are influenced by a number of factors including the demand for housing, conditions in the construction industry, and availability of funds. Sources of funds for lending activities include savings deposits, loan principal payments, proceeds from sales of loans, borrowings from the FHLB-Atlanta and other sources. Savings flows at thrift institutions such as the Bank are influenced by a number of factors including interest rates on competing investments and levels of personal income.



## **Earnings**

The Bank's earnings depend primarily on the difference between income from interest-earning assets such as loans and investments, and interest paid on interest-bearing liabilities such as deposits and borrowings. The Bank typically engages in long-term mortgage lending at fixed rates of interest, generally for periods of up to 30 years, while accepting deposits for considerably shorter periods. However, many of the Bank's long-term fixed-rate loans are sold in the secondary market, typically resulting in net gains on the sale of such loans by the Bank.

Generally, rapidly rising interest rates cause the cost of interest-bearing liabilities to increase more rapidly than yields on interest-earning assets, thereby adversely affecting the earnings of many thrift institutions. While the industry has received expanded lending and borrowing powers in recent years permitting different types of investments and mortgage loans, including those with floating or adjustable rates and those with shorter terms, earnings and operations are still highly influenced by levels of interest rates and financial market conditions and by substantial investments in long-term mortgage loans.

## **Competition**

The Annapolis, Maryland area has a high density of financial institutions, many of which are significantly larger and have greater financial resources than the Bank, and all of which are competitors of the Bank to varying degrees. The Bank's competition for loans comes primarily from savings and loan associations, savings banks, mortgage banking companies, insurance companies, and commercial banks. Many of the Bank's competitors have higher legal lending limits than the Bank. The Bank's most direct competition for deposits has historically come from savings and loan associations, savings banks, commercial banks, and credit unions. The Bank faces additional competition for deposits from short-term money market funds and other corporate and government securities funds. The Bank also faces increased competition for deposits from other financial institutions such as brokerage firms, insurance companies and mutual funds. The Bank is a community-oriented financial institution serving its market area with a wide selection of mortgage loans. Management considers the Bank's reputation for financial strength and customer service as its major competitive advantage in attracting and retaining customers in its market area. The Bank also believes it benefits from its community orientation.

## **Net Interest Income**

Net interest income increases during periods when the spread between Bancorp's weighted average rate at which new loans are originated and the weighted average cost of interest-bearing liabilities widens. Market factors such as interest rates, competition, consumer preferences, the supply of and demand for housing, and the availability of funds affect the Bank's ability to originate loans.

Bancorp has supplemented its interest income through purchases of investments when appropriate. This activity is intended to generate positive interest rate spreads on large principal balances with minimal administrative expense.

## **Interest Rate and Volume of Interest-Related Assets and Liabilities**

Both changes in rate and changes in the composition of Bancorp's interest-earning assets and interest-bearing liabilities can have a significant effect on net interest income.

For information concerning the extent to which changes in interest rates and changes in volume of interest-related assets and liabilities have affected Bancorp's interest income and expense during the fiscal years ended December 31, 2011 and 2010, refer to Item 6, "Selected Financial Data - Rate Volume Table".

## **Market Area**

The Bank's market area is primarily Anne Arundel County, Maryland and nearby areas, due to its four branch locations, all located in Anne Arundel County.

The Bank continues to expand its business relationship banking department by focusing on the needs of the business community in Anne Arundel County, Maryland. In addition, the Bank increased its offerings to businesses and consumers, including additional commercial lending products, business internet banking, and an expanded line of consumer deposit products. The Bank has traditionally focused its lending activities on first mortgage loans secured by real estate for the purpose of purchasing, refinancing, developing and constructing one-to-four family residences and commercial properties in and near Anne Arundel County, Maryland. While first mortgage lending has slowed due to the economic recession, the Bank continues to be a leading mortgage lender in its market area in 2011. The Bank participates in the secondary market and sells loans it originates either with mortgage servicing rights released or retained.

## **Supervisory Agreements**

On November 23, 2009, Bancorp and the Bank each entered into a supervisory agreement with the OTS, which agreements primarily addressed issues identified in the OTS' reports of examination of Bancorp's and the Bank's operations and financial condition conducted in 2009. The Supervisory Agreements provide, among other things, that

- Bancorp and Bank will not make any dividends or capital distributions, and Bancorp will not redeem any Bancorp common stock, without the prior approval of the OTS;
- Bancorp will not, and will not permit its subsidiaries to, incur, issue, renew or rollover any debt or debt securities, increase any current lines of credit, guarantee the debt of any entity, or otherwise incur any additional debt, without the prior written non-objection of the OTS;
- Bancorp and Bank will submit to OTS a business plan for 2010, 2011 and 2012 designed to, among other things, improve operations, earnings and profitability and reduce Bancorp debt and, after OTS approval, implement such plans and review such plans quarterly;
- Bank will develop and implement: (i) a plan to reduce the level of classified assets, assets designated special mention, all nonperforming assets and all delinquent loans, including specific workout plans for such assets and loans, or groups of such assets and loans, of \$1.5 million or more, (ii) revised policies, procedures, and methodology to ensure the timely establishment and maintenance of an adequate allowance for loan and lease loss level in accordance with applicable laws, regulations, and regulatory guidance, (iii) policies and procedures for the use of interest reserves, (iv) a program, subject to OTS approval, for identifying, monitoring, and managing risks associated with concentrations of credit, (v) a loan modification policy subject to OTS approval, (vi) policies and procedures for identifying and classifying problem assets, (vii) a revised liquidity and funds management policy, subject to OTS approval; the Board of Directors of the Bank is required to review these plans, policies and programs at regular intervals and take appropriate action;
- Bank will not increase the amount of brokered deposits without the prior approval of the OTS;
- Bank will establish a regulatory compliance committee, consisting of at least three non-employee directors, to monitor compliance with the supervisory agreement and the completion of all corrective action required in the OTS 2009 report of examination;
- Bank will not enter into any new, or renew, extend, or revise any existing, contractual arrangement relating to compensation or benefits for any senior executive officer or director of the Bank without prior notice to the OTS;

- Bank will not enter into any new arrangement or contract with a third party service provider outside of the normal course of business or otherwise in excess of \$100,000 per arrangement or contract per year without OTS prior non-objection; and
- Bancorp and Bank will make various periodic reports to the OTS and their respective boards of directors.

Due to the passage of the Dodd-Frank Act, effective July 21, 2011, the supervision of the Bank was transferred to the OCC and the supervision of Bancorp was transferred to the Federal Reserve. As a result, the Supervisory Agreement with the Bank is now enforced by the OCC and the terms will remain in effect until terminated, modified or suspended by the OCC. The Supervisory Agreement with Bancorp is now enforced by the Federal Reserve and the terms will remain in effect until terminated, modified or suspended by the Federal Reserve. The foregoing summary is qualified by reference to the Supervisory Agreements, copies of which are filed as exhibits to Bancorp's Annual Report on Form 10-K for fiscal year ended December 31, 2009 and filed with the Securities and Exchange Commission on March 15, 2010.

### Loan Portfolio Composition

The following table sets forth the composition of Bancorp's loan portfolios by type of loan at the dates indicated. The table includes a reconciliation of total net loans receivable, including loans held for sale, after consideration of undisbursed portion of loans, deferred loan fees and discounts, and allowances for losses on loans as of December 31:

	2011		2010		2009		2008		2007	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(dollars in thousands)									
Residential mortgage	\$295,876	39.78%	\$326,255	38.87%	\$343,931	37.97%	\$355,909	36.55%	\$320,303	32.45%
Construction and land acquisition and development	99,122	13.32%	144,098	17.17%	198,933	21.96%	242,359	24.89%	297,823	30.18%
Land	59,649	8.02%	63,155	7.52%	71,772	7.92%	82,642	8.49%	93,717	9.50%
Lines of credit	34,278	4.61%	36,642	4.37%	31,138	3.44%	34,872	3.58%	29,713	3.01%
Commercial real estate	203,010	27.29%	212,477	25.32%	204,596	22.59%	214,209	22.00%	205,755	20.85%
Commercial non-real estate	5,599	0.75%	8,434	1.00%	6,923	0.76%	3,084	0.32%	3,416	0.34%
Home equity	41,309	5.56%	43,501	5.18%	42,365	4.68%	39,040	4.01%	32,748	3.32%
Consumer	897	0.12%	1,302	0.16%	1,259	0.14%	1,083	0.11%	2,355	0.24%
Loans held for sale	4,128	0.55%	3,426	0.41%	4,845	0.54%	453	0.05%	1,101	0.11%
Total gross loans	743,868	100.00%	839,290	100.00%	905,762	100.00%	973,651	100.00%	986,931	100.00%
Deferred loan origination fees and costs, net	(2,485)		(3,205)		(3,895)		(4,439)		(4,898)	
Loans in process	(18,014)		(23,851)		(48,095)		(57,940)		(78,238)	
Allowance for loan losses	(25,938)		(29,871)		(34,693)		(14,813)		(10,781)	
Total loans net	\$697,431		\$782,363		\$819,079		\$896,459		\$893,014	

## Lending Activities

### General

The Bank originates mortgage loans of all types, including residential, residential-construction, commercial-construction, commercial, land and residential lot loans. The Bank also originates non-mortgage loans, which include consumer, business and commercial loans. These loans constitute a small part of the Bank's portfolio.

The Bank originated and funded \$95,586,000 and \$144,313,000 of mortgage loans for the years ended December 31, 2011 and 2010, respectively.

### Loan Origination Procedures

The following table contains information on the activity of the Bank's loans held for sale and its loans held for investment in its portfolio:

	For the Years Ended December 31,		
	2011	2010	2009
	(dollars in thousands)		
Held for Sale:			
Beginning balance	\$3,426	\$4,845	\$453
Originations	43,403	62,654	33,692
Net sales	(42,701)	(64,073)	(29,300)
Ending balance	<u>\$4,128</u>	<u>\$3,426</u>	<u>\$4,845</u>
Held for investment:			
Beginning balance	\$835,864	\$900,917	\$973,198
Originations and purchases	52,183	94,892	128,417
Transfers to foreclosed real estate	(19,820)	(32,283)	(35,931)
Repayments/payoffs	(128,487)	(127,662)	(164,767)
Ending balance	<u>\$739,740</u>	<u>\$835,864</u>	<u>\$900,917</u>

The Bank originates residential mortgage loans that are to be held in the Bank's loan portfolio as well as loans that are intended for sale in the secondary market. Loans sold in the secondary market are primarily sold to investors with which the Bank maintains a correspondent relationship. These loans are made in conformity with standard underwriting criteria to assure maximum eligibility for possible resale in the secondary market, and are approved either by the Bank's underwriter or the correspondent's underwriter. Loans considered for the Bank's portfolio are approved by the Bank's loan committee, which includes the Chief Executive Officer, the Chief Operating Officer, the Chief Relationship Officer and the Senior Vice President of Credit Officer. Meetings of the loan committee are open to attendance by any member of the Bank's Board of Directors who wishes to attend. The loan committee reports to and consults with the Board of Directors in interpreting and applying the Bank's lending policy. Single loans greater than \$2,000,000, or loans to one borrower aggregating more than \$4,000,000, up to \$17,284,000 (the maximum amount of loans to one borrower as of December 31, 2011), must also have Board of Directors' approval.

Loans that are sold are typically long-term (15 or more years) loans with fixed interest rates eligible for resale in the secondary market. Loans retained for Bancorp's portfolio typically include construction loans, commercial loans and loans that periodically reprice or mature prior to the end of an amortized term. Loans are sold with either servicing released or retained by the Bank. As of December 31, 2011, the Bank was servicing \$13,200,000 in loans for Federal Home Loan Mortgage Corporation ("FHLMC") and \$71,545,000 in loans for other investors.

The following table contains information, as of December 31, 2011, on the percentage of fixed-rate single-family loans serviced for others by the Bank, by interest rate category.

<u>Interest rate range</u>	<u>Percentage of Portfolio</u>
Less than 5.00%	89.8%
5.01 – 6.00%	7.2%
6.01 – 7.00%	1.7%
7.01 – 8.00%	0.9%
Over 8.00%	0.4%
	<u>100.0%</u>

The Bank's mortgage loan approval process is intended to assess the borrower's ability to repay the loan, the viability of the loan, and the adequacy of the value of the property that will secure the loan. The authority of the loan committee to approve loans is established by the Board of Directors and currently is commensurate with the Bank's limitation on loans to one borrower. The Bank's maximum amount of loans to one borrower currently is equal to 15% of the Bank's unimpaired capital, or \$17,284,000 as of December 31, 2011. Loans greater than this amount require participation by one or more additional lenders. Letters of credit are subject to the same limitations as direct loans. The Bank utilizes independent qualified appraisers approved by the Board of Directors to appraise the properties securing its loans and requires title insurance or title opinions so as to insure that the Bank has a valid lien on the mortgaged real estate. The Bank requires borrowers to maintain fire and casualty insurance on its secured properties.

The procedure for approval of construction loans is the same for residential mortgage loans, except that the appraiser evaluates the building plans, construction specifications, and estimates of construction costs. The Bank also evaluates the feasibility of the proposed construction project and the experience and track record of the developer. In addition, all construction loans generally require a commitment from a third-party lender or from the Bank for a permanent long-term loan to replace the construction loan upon completion of construction.

### **Residential Mortgage Loans**

At December 31, 2011, Bancorp's residential mortgage loan portfolio totaled \$295,876,000, or 39.8% of Bancorp's loan portfolio. All of Bancorp's residential mortgage loans are secured by one to four family residential properties. Loans secured by residential properties generally have less risk than other loans because they are generally the primary residence of the borrower.

### **Commercial Real Estate Loans**

At December 31, 2011, Bancorp's commercial real estate loan portfolio totaled \$203,010,000, or 27.3% of Bancorp's loan portfolio. All of Bancorp's commercial real estate loans are secured by improved property such as office buildings, retail strip shopping centers, industrial condominium units and other small businesses, most of which are located in the Bank's primary lending area. The largest commercial real estate loan outstanding at December 31, 2011 was a \$6,889,000 loan secured by an office building in Annapolis, Maryland. This loan has consistently performed in accordance with the terms of the debt instrument.

Loans secured by commercial real estate properties generally involve a greater degree of risk than residential mortgage loans. Because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to a greater extent to adverse conditions in the real estate market or the economy.

### **Construction and Land Acquisition and Development Loans**

The Bank originates loans to finance the construction of one-to-four family dwellings, and to a lesser extent, commercial real estate. It also originates loans for the acquisition and development of unimproved property to be used for residential and/or commercial purposes in cases where the Bank is to provide the construction funds to improve the properties. As of December 31, 2011, Bancorp had 101 construction loans outstanding in the gross aggregate amount of \$99,122,000, representing 13.3% of its loan portfolio, and had commitments to advance an additional \$18,014,000.

Construction loan amounts are based on the appraised value of the property and, for builder loans, a feasibility study as to the potential marketability and profitability of the project. Construction loans generally have terms of up to one year, with reasonable extensions as needed, and typically have interest rates that float monthly at margins ranging from the prime rate to 2 percent above the prime rate. In addition to builders' projects, the Bank finances the construction of single family, owner-occupied houses where qualified contractors are involved and on the basis of strict written underwriting and construction loan guidelines. Construction loans are structured either to be converted to permanent loans with the Bank upon the expiration of the construction phase or to be paid off by financing from another financial institution.

Construction loans afford the Bank the opportunity to increase the interest rate sensitivity of its loan portfolio and to receive yields higher than those obtainable on loans secured by existing residential properties. These higher yields correspond to the higher risks associated with construction lending. Construction loans involve additional risks attributable to the fact that loan funds are advanced upon the security of the project under construction that is of uncertain value prior to its completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of the completed project and the effects of governmental regulation of real property, it is relatively difficult to value accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the ultimate success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank is forced to foreclose on a project prior to or at completion, due to a default, there can be no assurance that the Bank will be able to recover all of the unpaid balance of the loan as well as related foreclosure and holding costs. In addition, the Bank may be required to fund additional amounts to complete the project and may have to hold the property for an unspecified period of time. The Bank has attempted to address these risks through its underwriting procedures and its limited amount of construction lending on multi-family and commercial real estate properties.

It is the policy of the Bank to conduct physical inspections of each property secured by a construction or rehabilitation loan for the purpose of reporting upon the progress of the construction of improvements. These inspections, referred to as "construction draw inspections," are to be performed at the time of a request for an advance of construction funds. If no construction advance has been requested, a fee inspector or senior officer of the institution makes an inspection of the subject property at least quarterly.

### **Land and Residential Building Lots**

Land loans include loans to developers for the development of residential subdivisions and loans on unimproved lots primarily to individuals. At December 31, 2011, Bancorp had outstanding land and residential building lot loans totaling \$59,649,000, or 8.0% of the total loan portfolio. The largest of these loans for \$7,045,000, is secured by thirty lots in Davidsonville, Maryland, and has performed in accordance with the terms of the debt instrument. Land development loans typically are short-term loans; the duration of these loans is typically not greater than three years. The interest rate on land loans is generally at least 1% or 2% over the prime rate. The loan-to-value ratio generally does not exceed 75% at the time of loan origination. Land and residential building lot loans typically are made to customers of the Bank and developers and contractors with whom the Bank has had previous lending experience. In addition to the customary requirements for these types of loans, the Bank may also require a satisfactory Phase I environmental study and feasibility study to determine the profit potential of the development.

### **Other Business and Commercial Loans**

The Bank also offers other business and commercial loans. These are loans to businesses are typically lines of credit or other loans that are not secured by real estate, although equipment, securities, or other collateral may secure them. They typically are offered to customers with long-standing relationships with the Bank. At December 31, 2011, \$39,877,000, or 5.4%, of the loan portfolio consisted of lines of credit and other commercial loans.

### **Home Equity and Other Consumer Loans**

The Bank also offers other loans to consumers, including home equity loans, home equity lines of credit and other consumer loans. At December 31, 2011, \$42,206,000, or 5.7% of the loan portfolio consisted of these loans.

### **Loan Portfolio Cash Flows**

The following table sets forth the estimated maturity of Bancorp's loan portfolios by type of loan at December 31, 2011. The estimated maturity reflects contractual terms at December 31, 2011. Contractual principal repayments of loans do not necessarily reflect the actual life of the Bank's loan portfolios. The average life of mortgage loans is substantially less than their contractual terms because of loan prepayments and because of enforcement of "due on sale" clauses. The average life of mortgage loans tends to increase, however, when current mortgage loan rates substantially exceed rates on existing mortgage loans.

	Due Within one year or less	Due after 1 through 5 years	Due after 5 years	Total
		(dollars in thousands)		
Residential mortgage	\$18,649	\$63,029	\$218,326	\$300,004
Home equity	-	78	41,231	41,309
Lines of credit	22,802	7,584	3,892	34,278
Commercial real estate	13,081	90,844	99,085	203,010
Acquisition and development	84,545	14,577	-	99,122
Land	33,149	16,291	10,209	59,649
Commercial, non-real estate	835	3,494	1,270	5,599
Consumer	121	588	188	897
Total	<u>\$173,182</u>	<u>\$196,485</u>	<u>\$374,201</u>	<u>\$743,868</u>



The following table contains certain information as of December 31, 2011 relating to the loan portfolio of Bancorp with the dollar amounts of loans due after one year that have fixed and floating rates. All loans are shown maturing based upon contractual maturities and include scheduled payments but not possible prepayments.

	Fixed	Floating	Total
	(dollars in thousands)		
Residential mortgage	\$173,499	\$107,856	\$281,355
Home equity	-	41,309	41,309
Lines of credit	-	11,476	11,476
Commercial real estate	91,074	98,855	189,929
Acquisition and development	8,788	5,789	14,577
Land	15,120	11,380	26,500
Commercial, non-real estate	4,329	435	4,764
Consumer	776	-	776
Total	<u>\$293,586</u>	<u>\$277,100</u>	<u>\$570,686</u>

### **Loans to One Borrower**

Under regulatory guidelines, the aggregate amount of loans that the Bank may make to one borrower was \$17,284,000 at December 31, 2011, which is 15% of the Bank's unimpaired capital and unimpaired surplus. The Bank's three largest loans at December 31, 2011 were a \$7,045,000 loan secured by residential lots in Davidsonville, Maryland, a \$6,889,000 loan secured by an office building located in Annapolis, Maryland, and a \$5,700,000 loan secured by commercial property located in Norfolk, Virginia. All three loans are performing as agreed.

### **Origination and Purchase and Sale of Loans**

The Bank originates residential loans in conformity with standard underwriting criteria to assure maximum eligibility for possible resale in the secondary market. Although the Bank has authority to lend anywhere in the United States, it has confined its loan origination activities primarily to the states of Maryland, Virginia and Delaware.

Loan originations are developed from a number of sources, primarily from referrals from real estate brokers, internet leads, builders, and existing and walk-in customers.

The Bank's mortgage loan approval process is intended to assess the borrower's ability to repay the loan, the viability of the loan, and the adequacy of the value of the property that will secure the loan. The loan committee of the Bank can approve single residential and commercial loans up to \$2,000,000, and loans that aggregate up to \$4,000,000 to one borrower. Single loans greater than \$2,000,000, or loans to one borrower aggregating more than \$4,000,000, up to \$17,284,000 (the maximum amount of loans to one borrower as of December 31, 2011), must also have Board of Directors' approval. The Bank utilizes independent qualified appraisers approved by the Board of Directors to appraise the properties securing its loans and requires title insurance or title opinions so as to insure that the Bank has a valid lien on the mortgaged real estate. The Bank requires borrowers to maintain fire and casualty insurance on its secured properties.

The procedure for approval of construction loans is the same as for residential mortgage loans, except that the appraiser evaluates the building plans, construction specifications, and estimates of construction costs. The Bank also evaluates the feasibility of the proposed construction project and the experience and track record of the developer. In addition, all construction loans generally require a commitment from a third-party lender or from the Bank for a permanent long-term loan to replace the construction loan upon completion of construction.

Consumer loans are underwritten on the basis of the borrower's credit history and an analysis of the borrower's income and expenses, ability to repay the loan, and the value of the collateral, if any.

Currently, it is the Bank's policy to originate both fixed-rate and adjustable-rate loans. The Bank is currently active in the secondary market and sells a portion of its fixed-rate loans.

### **Interest Rates, Points and Fees**

The Bank realizes interest, point, and fee income from its lending activities. The Bank also realizes income from commitment fees for making commitments to originate loans, and from prepayment and late charges, loan fees, application fees, and fees for other miscellaneous services.

The Bank accounts for loan origination fees in accordance with standards set on the accounting for deferred costs and fees. These standards prohibit the immediate recognition of loan origination fees as revenues and require that such income (net of certain direct loan origination costs) for each loan be amortized, generally by the interest method, over the estimated life of the loan as an adjustment of yield. The Bank also realizes income from gains on sales of loans, and servicing released fees for loans sold with servicing released.

### **Delinquencies and Classified Assets and Allowance for Loan Losses**

#### **Delinquencies**

The Board of Directors reviews delinquencies on all loans monthly. The Bancorp's collection procedures include sending a past due notice to the borrower on the 17th day of nonpayment, making telephone contact with the borrower between 20 and 30 days after nonpayment, and sending a letter after the 30th day of nonpayment. A notice of intent to foreclose is sent between 60 and 90 days after delinquency. When the borrower is contacted, Bancorp attempts to obtain full payment of the past due amount. However, Bancorp generally will seek to reach agreement with the borrower on a payment plan to avoid foreclosure.

An allowance for loan losses is provided through charges to income in an amount that management believes will be adequate to absorb losses on existing loans that may become uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Determining the amount of the allowance for loan losses requires the use of estimates and assumptions, which is permitted under generally accepted accounting principles. Actual results could differ significantly from those estimates. Management believes the allowance for losses on loans is adequate. While management uses available information to estimate losses on loans, future additions to the allowances may be necessary based on changes in economic conditions, particularly in the State of Maryland. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for losses on loans. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. When a real estate secured loan becomes impaired, a decision is made as to whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable agings or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information and the quality of the assets.

For such loans that are classified as impaired, an allowance is established when the current market value of the underlying collateral less its estimated disposal costs is lower than the carrying value of that loan. For loans that are not solely collateral dependent, an allowance is established when the present value of the expected future cash flows of the impaired loan is lower than the carrying value of that loan. The general component relates to loans that are classified as doubtful, substandard or special mention that are not considered impaired, as well as non-classified loans. The general reserve is based on historical loss experience adjusted for qualitative factors. These qualitative factors include:

- Levels and trends in delinquencies and nonaccruals;
- Inherent risk in the loan portfolio;
- Trends in volume and terms of the loan;
- Effects of any change in lending policies and procedures;
- Experience, ability and depth of management;
- National and local economic trends and conditions; and
- Effect of any changes in concentration of credit.

A loan is considered impaired if it meets either of the following two criteria:

- Loans that are 90 days or more in arrears (nonaccrual loans); or
- Loans where, based on current information and events, it is probable that a borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

A loan is considered a troubled debt restructuring when Bancorp for economic or legal reasons relating to the borrowers financial difficulties grants a concession to the borrower that it would not otherwise consider. Loan modifications made with terms consistent with current market conditions that the borrower could obtain in the open market are not considered troubled debt restructurings.

Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

The Bank discontinues the accrual of interest on loans 90 days or more past due, at which time all previously accrued but uncollected interest is deducted from income. \$2,905,000 in interest income would have been recorded for the year ended December 31, 2011 if the loans had been current in accordance with their original terms and had been outstanding throughout the year ended December 31, 2011 or since their origination (if held for only part of the fiscal year). For the year ended December 31, 2011, \$822,000 in interest income on such loans was actually included in net income. The following table sets forth information as to non-accrual loans and other non-performing assets.

	At December 31,				
	2011	2010	2009	2008	2007
	(dollars in thousands)				
Loans accounted for on a non-accrual basis:					
Residential mortgage	\$8,912	\$18,778	\$33,391	\$35,829	\$4,992
Construction and land acquisition and development	10,997	15,160	-	-	-
Land	6,813	5,890	19,425	15,721	2,372
Lines of credit	2,019	4,265	-	-	-
Commercial real estate	2,140	1,927	7,400	3,047	336
Commercial non-real estate	5	-	56	-	-
Home Equity	343	118	536	189	-
Consumer	203	26	-	-	-
Total non-accrual loans	<u>\$31,432</u>	<u>\$46,164</u>	<u>\$60,808</u>	<u>\$54,786</u>	<u>\$7,700</u>
Accruing loans greater than 90 days past due	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>
Foreclosed real-estate	<u>\$19,932</u>	<u>\$20,955</u>	<u>\$21,574</u>	<u>\$6,317</u>	<u>\$2,993</u>
Total non-performing assets	<u>\$51,364</u>	<u>\$67,119</u>	<u>\$82,382</u>	<u>\$61,103</u>	<u>\$10,693</u>
Total troubled debt restructurings	<u>\$59,775</u>	<u>\$72,029</u>	<u>\$44,716</u>	<u>\$2,142</u>	<u>\$-</u>
Total non-accrual loans to net loans	<u>4.5%</u>	<u>5.9%</u>	<u>7.5%</u>	<u>6.1%</u>	<u>0.9%</u>
Allowance for loan losses to total non-performing loans, including loans contractually past due 90 days or more	<u>82.5%</u>	<u>64.7%</u>	<u>57.1%</u>	<u>27.0%</u>	<u>140.0%</u>
Total non-accrual and accruing loans greater than 90 days past due to total assets	<u>3.5%</u>	<u>4.8%</u>	<u>7.5%</u>	<u>6.1%</u>	<u>0.8%</u>
Total non-performing assets to total assets	<u>5.7%</u>	<u>7.5%</u>	<u>10.1%</u>	<u>6.8%</u>	<u>1.1%</u>

Included in non-accrual residential mortgage loans at December 31, 2011 were 20 loans totaling \$7,640,000 to consumers and 5 loans totaling \$1,272,000 to builders. Included in non-accrual land loans at December 31, 2011 were 14 loans.

## **Classified Assets and Allowance for Loan Losses**

Federal regulations provide for the classification of loans and other assets, such as debt and equity securities, considered by the OCC to be of lesser quality, as “substandard,” “doubtful” or “loss assets.” An asset is considered substandard if the paying capacity and net worth of the obligor or the collateral pledged, if any, inadequately protects it. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable, on the basis of currently existing facts, conditions, and values. Assets classified as loss assets are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not currently expose the insured institution to a sufficient degree of risk to warrant classification in one of these categories but possess credit deficiencies or potential weakness are required to be designated special mention by management.

When an insured institution classifies problem assets as either substandard or doubtful, it is required to establish general allowances for losses in an amount deemed prudent by management. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as loss assets, it is required either to establish a specific allowance for losses equal to the full amount of the asset so classified or to charge-off such amount. An institution’s determination as to the classification of its assets is subject to scrutiny by the OCC, which can require the establishment of additional general or specific loss allowances. The Bank reviews monthly the assets in its portfolio to determine whether any assets require classification in accordance with applicable regulations.

Total classified loans as of December 31, 2011 were \$88,109,000 of which \$87,877,000 were classified substandard and \$232,000 were classified doubtful. The allowance for loan losses as of December 31, 2011 was \$25,938,000, which was 3.6% of gross loans receivable and 82.5% of total non-performing loans.

[see table on following page]

The following table summarizes the allocation of the allowance for loan losses by loan type and the percent of loans in each category compared to total loans (excluding loans held for sale) as of December 31,

	2011			2010			2009			2008			2007		
	Allowance	Percentage of		Allowance	Percentage of		Allowance	Percentage of		Allowance	Percentage of		Allowance	Percentage of	
	Amount	Loans in each		Amount	Loans in each		Amount	Loans in each		Amount	Loans in each		Amount	Loans in each	
		Category to			Category to			Category to			Category to			Category to	
		Total Loans			Total Loans			Total Loans			Total Loans			Total Loans	
Residential mortgage	\$12,303	40.00%		\$16,339	39.03%		\$19,621	38.17%		\$5,765	36.57%		\$3,378	32.49%	
Construction and land acquisition and development loans	3,916	13.40%		3,997	17.24%		1,492	22.08%		2,559	24.90%		1,849	30.21%	
Land	2,405	8.06%		4,225	7.56%		5,539	7.97%		3,286	8.49%		2,027	9.51%	
Lines of credit	725	4.63%		458	4.38%		20	3.46%		-	3.58%		-	3.01%	
Commercial real estate	4,157	27.44%		3,949	25.42%		5,506	22.71%		3,080	22.01%		3,332	20.87%	
Commercial non-real estate	169	0.76%		131	1.01%		82	0.77%		77	0.32%		150	0.35%	
Home equity	2,257	5.58%		762	5.20%		2,425	4.70%		42	4.01%		35	3.32%	
Consumer	6	0.13%		10	0.16%		8	0.14%		4	0.12%		10	0.24%	
Total	\$25,938	100.00%		\$29,871	100.00%		\$34,693	100.00%		\$14,813	100.00%		\$10,781	100.00%	

The following table contains information with respect to Bancorp's allowance for loan losses for the periods indicated:

	At of or for the Year Ended				
	December 31				
	2011	2010	2009	2008	2007
	(dollars in thousands)				
Average loans outstanding, net	\$753,926	\$823,410	\$878,191	\$893,030	\$858,305
Total gross loans outstanding at end of period	\$743,868	\$839,290	\$905,762	\$973,651	\$986,931
Total net loans outstanding at end of period	\$697,431	\$782,363	\$819,079	\$896,459	\$893,014
Allowance balance at beginning of period	\$29,871	\$34,693	\$14,813	\$10,781	\$9,026
Provision for loan losses	4,612	5,744	31,402	7,481	2,462
Actual charge-offs					
Residential real estate	4,421	6,825	6,761	2,571	270
Acquisition and development	1,503	-	-	-	-
Land	1,054	3,096	-	-	-
Commercial real estate	811	523	-	-	-
Home Equity	39	217	-	-	-
Consumer	717	5	-	-	-
Other	-	-	4,818	878	449
Total charge-offs	8,545	10,666	11,579	3,449	719
Recoveries					
Residential real estate	-	100	57	-	12
Total recoveries	-	100	57	-	12
Net charge offs	8,545	10,566	11,522	3,449	707
Allowance balance at end of period	\$25,938	\$29,871	\$34,693	\$14,813	\$10,781
Net charge offs as a percent of average loans	1.13%	1.28%	1.31%	0.39%	0.08%
Allowance for loan losses to total gross loans at end of period	3.49%	3.56%	3.83%	1.52%	1.09%
Allowance for loan losses to net loans at end of period	3.72%	3.82%	4.24%	1.65%	1.21%

## Investment Activities

Federal thrift institutions, such as the Bank, have authority to invest in various types of liquid assets, including United States Treasury obligations and securities of various federal agencies, certificates of deposit at insured banks, bankers' acceptances and federal funds. As a member of the FHLB System, the Bank must maintain minimum levels of liquid assets specified by the OCC, which vary from time to time. Subject to various regulatory restrictions, federal thrift institutions may also invest a portion of their assets in certain commercial paper, corporate debt securities and mutual funds whose assets conform to the investments that a federal thrift institution is authorized to make directly.

The amortized cost of the Bank's investment securities held to maturity, as of the dates indicated are presented in the following table:

	At December 31,		
	2011	2010	2009
	(dollars in thousands)		
US Treasury securities	\$34,498	\$21,104	\$6,999
US Agency securities	5,206	5,233	-
US Government sponsored mortgage-backed securities	653	974	1,032
Total Investment Securities Held to Maturity	<u>\$40,357</u>	<u>\$27,311</u>	<u>\$8,031</u>



# Investment Scheduled Maturity Table

As of December 31, 2011

	One Year or Less			More than One to Five Years			More than Five to Ten Years			More than Ten Years			Total Investment Securities		
	Weighted			Weighted			Weighted			Weighted			Weighted		
	Amortized	Average	Yield	Amortized	Average	Yield	Amortized	Average	Yield	Amortized	Average	Yield	Amortized	Average	Fair Value
	Cost			Cost			Cost			Cost			Cost		
	(dollars in thousands)														
US Treasury securities	\$5,998	0.65%		\$23,406	1.72%		\$5,094	2.72%		\$ -	-		\$34,498	1.68%	\$35,778
US Agency securities	1,002	0.54%		4,204	1.23%		-	-		-	-		5,206	1.10%	5,245
US Government sponsored mortgage-backed securities*	-	-		-	-		251	5.19%		402	5.29%		653	5.25%	701
Total securities	\$7,000	0.63%		\$27,610	1.65%		\$5,345	2.83%		\$402	5.29%		\$40,357	1.67%	\$41,724

\* The amortized cost of mortgage-backed securities as of December 31, 2011, by contractual maturity, is shown above. Expected maturities may differ from contractual maturities because the securities may be called or prepaid with or without prepayment penalties.

## Deposits

Deposits are attracted principally from within the Bank's primary market areas through the offering of a variety of deposit instruments, including passbook and statement accounts and certificates of deposit ranging in terms from three months to five years. Deposit account terms vary, principally on the basis of the minimum balance required, the time periods the funds must remain on deposit and the interest rate. The Bank also offers individual retirement accounts.

The Bank's policies are designed primarily to attract deposits from local residents rather than to solicit deposits from areas outside the Bank's primary markets. Interest rates paid, maturity terms, service fees and withdrawal penalties are established by the Bank on a periodic basis. Determination of rates and terms are predicated upon funds acquisition and liquidity requirements, rates paid by competitors, growth goals and federal regulations.

Deposits in the Bank as of December 31, 2011, 2010 and 2009 consisted of savings programs described below:

	2011	2010	2009
	(dollars in thousands)		
NOW accounts	\$ 16,654	\$ 13,465	\$ 12,898
Money market accounts	43,344	41,168	49,797
Passbooks	189,696	222,183	184,311
Certificates of deposit	383,103	420,133	447,889
Non-interest bearing accounts	19,960	17,827	15,434
Total deposits	<u>\$652,757</u>	<u>\$714,776</u>	<u>\$710,329</u>

The following table contains information pertaining to the certificates of deposit held by the Bank in excess of \$100,000 as of December 31, 2011.

	Jumbo Certificates of Deposit (dollars in thousands)
<u>Time Remaining Until Maturity</u>	
Less than three months	\$ 17,479
3 months to 6 months	23,558
6 months to 12 months	64,715
Greater than 12 months	<u>59,125</u>
Total	<u>\$164,877</u>

### **Liquidity and Asset/Liability Management**

Two major objectives of asset and liability management are to maintain adequate liquidity and to control the interest sensitivity of the balance sheet.

Liquidity is the measure of a company's ability to maintain sufficient cash flow to fund operations and to meet financial obligations to depositors and borrowers. Liquidity is provided by the ability to attract and retain deposits and by principal and interest payments on loans and maturing securities in the investment portfolio. A strong core deposit base, supplemented by other deposits of varying maturities and rates, contributes to the Bank's liquidity.

Management believes that funds available through short-term borrowings and asset maturities are adequate to meet all anticipated needs, and management is continually monitoring the Bank's liquidity position to meet projected needs.

Interest rate sensitivity is maintaining the ability to reprice interest earning assets and interest bearing liabilities in relationship to changes in the general level of interest rates. Management attributes interest rate sensitivity to a steady net interest margin through all phases of interest rate cycles. Management attempts to make the necessary adjustments to constrain adverse swings in net interest income resulting from interest rate movements through gap analysis and income simulation modeling techniques.

### **Borrowings**

The Bank's credit availability under the FHLB of Atlanta's credit availability program was \$184,400,000 at December 31, 2011. The Bank is able to borrow up to 20% of total assets. The Bank, from time to time, utilizes the line of credit when interest rates are more favorable than obtaining deposits from the public. The following table sets forth short-term borrowings with the FHLB-Atlanta, with original maturities of one year or less.

	Years ended December 31,		
	2011	2010	2009
	(dollars in thousands)		
Short-term borrowings			
Average balance outstanding during the period	\$-	\$-	\$596
Maximum amount outstanding at any month-end during the period	-	-	7,000
Weighted average interest rate during the period	-	-	2.04%
Total short-term borrowings at period end	-	-	-
Weighted average interest rate at period end	-	-	-

## **Employees**

As of December 31, 2011, Bancorp and its subsidiaries had approximately 127 full-time equivalent employees. Bancorp's employees are not represented by any collective bargaining group.

## **Hyatt Commercial**

Hyatt Commercial is a real estate brokerage company specializing in commercial real estate sales, leasing and property management. During the quarter ended September 30, 2009, the common stock of Hyatt Commercial was contributed to the Bank from Bancorp.

## **SBI Mortgage Company**

SBI is a subsidiary of Bancorp that has engaged in the origination of mortgages not suitable for the Bank. It owns subsidiary companies that purchase real estate for investment purposes. As of December 31, 2011, SBI had \$2,212,000 in outstanding mortgage loans and it had \$469,000 invested in subsidiaries, which funds were held in cash, pending potential acquisition of investment real estate.

## **Crownsville Development Corporation**

Crownsville, which is doing business as Annapolis Equity Group, is a subsidiary of SBI and is engaged in the business of acquiring real estate for investment and syndication purposes.

## **HS West, LLC**

HS West, LLC ("HS") is a subsidiary of the Bank, and constructed a building in Annapolis, Maryland that serves as Bancorp's and the Bank's administrative headquarters. A branch office of the Bank is also located in the building. In addition, HS leases space to four unrelated companies and to a law firm of which the President of Bancorp and the Bank is a partner.

## **Severn Financial Services Corporation**

Severn Financial Services Corporation is a subsidiary of the Bank that is part of a joint venture with a local insurance agency to provide various insurance products to customers of Bancorp.

## **Homeowners Title and Escrow Corporation**

Homeowners Title and Escrow Corporation, is a subsidiary of the Bank, that was engaged in the business of conducting loan settlements for the Bank. During 2008, Homeowners Title and Escrow Corporation ceased operations.

## **Regulation**

The financial services industry in the Bank's market area is highly competitive, including competition from commercial banks, savings banks, credit unions, finance companies and non-bank providers of financial services. Several of the Bank's competitors have legal lending limits that exceed that of the Bank's, as well as funding sources in the capital markets that exceeds the Bank's availability. The increased competition has resulted from a changing legal and regulatory climate, as well as from the economic climate.

### ***General***

Savings and loan holding companies and savings associations are extensively regulated under both federal and state law. This regulation is intended primarily to protect depositors and the Deposit Insurance Fund ("DIF"), and not the stockholders of Bancorp. The summary below describes briefly the regulation that is applicable to Bancorp and the Bank, does not purport to be complete and is qualified in its entirety by reference to applicable laws and regulations.

### ***Regulatory Reform and Legislation***

On July 21, 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This new law has significantly changed the bank regulatory structure and significantly impacted the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies have been given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and future impact of the Dodd-Frank Act may not be known for many months or years. The discussion below generally discusses the material provisions of the Dodd-Frank Act applicable to Bancorp and the Bank and is not complete or meant to be an exhaustive discussion.

Certain provisions of the Dodd-Frank Act have already affected Bancorp. Effective July 21, 2011, the OTS, which was the primary federal regulator for Bancorp and the Bank, was abolished and replaced by the FRB with respect to savings and loan holding companies and their non-depository institution subsidiaries, including Bancorp, and the OCC with respect to federal savings associations, including the Bank.

The Dodd-Frank Act also created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than \$10 billion in assets. Savings institutions with \$10 billion or less in assets, such as the Bank, continue to be examined for compliance with the consumer laws by their primary bank regulators.

Effective July 21, 2011, the federal prohibitions on paying interest on demand deposits were eliminated, thus allowing businesses to have interest bearing checking accounts.

The Dodd-Frank Act weakened the federal preemption rules applicable to national banks and federal savings associations, allowing federal law to preempt state law only where state law would have a discriminatory effect on federal savings associations or is preempted by other federal law. The OCC has the authority to make preemption determinations and must make each determination on a case by case basis.

The Dodd-Frank Act directs the FDIC to redefine the base for deposit insurance assessments paid by banks. Assessments will now be based on the average consolidated total assets less tangible equity of a financial institution. This change may proportionally shift deposit insurance funding away from banks that rely primarily on deposits for funding operations, like the Bank. The Dodd-Frank Act also permanently increases the maximum amount of deposit insurance for banks, savings institutions and credit unions to \$250,000 per depositor, and extends the FDIC's program of insuring non-interest bearing transaction accounts on an unlimited basis through December 31, 2012.

The minimum reserve ratio for the Deposit Insurance Fund has been increased from 1.15% to 1.35% of estimated insured deposits.

The Dodd-Frank Act amends the Home Owners Loan Act (HOLA) to require that leverage capital requirements and risk based capital requirements applicable to depository and bank holding companies be extended to thrift holding companies. It also applies the Federal Reserve Board's "source of strength" doctrine, which has long applied to bank holding companies, to savings and loan holding companies. Pursuant to the doctrine, regulatory agencies must issue regulations requiring holding companies to act as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

The Dodd-Frank Act also includes several provisions regarding executive compensation. Publicly traded companies must give stockholders a non-binding vote on executive compensation and so called "golden parachute" payments. Companies will be required to disclose the relationship between executive compensation and financial performance of the issuer in annual proxy materials.

It is difficult to predict the exact impact the Dodd-Frank Act and the implementing rules and regulations will have on savings and loan holding companies and banks. The Dodd-Frank Act and resulting rules and regulations may impact the profitability of our business or change certain of our business practices, including our ability to offer new products, make loans and achieve satisfactory interest spreads, and could expose us to additional costs, including increased regulatory compliance costs. The changes also may require us to invest significant management attention and resources to make any necessary changes to our operations in order to comply, and could materially adversely affect our business, results of operations and financial condition. The following provides a description of the current regulations that are applicable to Bancorp and the Bank and selected changes to be implemented pursuant to the Dodd-Frank Act, all of which are subject to further change as additional provisions of the Dodd-Frank Act are implemented.

### ***Regulation of Bancorp***

***General.*** As previously noted the Dodd-Frank Act eliminated the OTS and transferred supervision of savings and loan holding companies to the FRB on July 21, 2011. As a unitary savings and loan holding company, Bancorp is now required to register and file reports with the FRB and is subject to regulation and examination by the FRB. In addition, the FRB has enforcement authority over Bancorp and its subsidiaries, which permits the FRB to restrict or prohibit activities determined to be a serious risk to the subsidiary savings association.

***Activities Restriction Test.*** As a unitary savings and loan holding company, Bancorp generally is not subject to activity restrictions, provided the Bank satisfies the Qualified Thrift Lender ("QTL") test. The termination of the "unitary thrift holding company exemption" in 1999 did not affect Bancorp because Bancorp was grandfathered under the law. Under certain circumstances, Bancorp could lose its grandfathered status. If the Bank failed to meet the QTL test, then Bancorp would become subject to the activities restrictions applicable to multiple savings and loan holding companies and, unless the Bank qualified as a QTL within one year thereafter, Bancorp would be required to register as, and would become subject to the restrictions applicable to, a bank holding company. Additionally, if Bancorp acquired control of another savings association, either through merger or other combination with the Bank, other than in a supervisory acquisition where the acquired association also met the QTL test, Bancorp would thereupon become a multiple savings and loan holding company and thereafter be subject to further restrictions on its activities. Bancorp presently intends to continue to operate as a unitary savings and loan holding company.

***Restrictions on Acquisitions.*** Except under limited circumstances, savings and loan holding companies, such as Bancorp, are prohibited from (i) acquiring, without prior approval of the FRB, more than 5% of the voting shares of a savings association or a holding company which is not a subsidiary thereof or (ii) acquiring control of an uninsured institution, or retaining, for more than one year after the date of any savings association becomes uninsured, control of such association. In evaluating proposed acquisitions of savings institutions by holding companies, the FRB considers the financial and managerial resources and future prospects of the holding company and the target institution, the effect of the acquisition on the risk to the DIF, the convenience and the needs of the community and competitive factors.

No director or officer of a savings and loan holding company or person owning or controlling by proxy or otherwise more than 25% of such company's stock, may acquire control of any savings association, other than a subsidiary savings association, or of any other savings and loan holding company, without written approval of the FRB. Certain individuals, including Alan J. Hyatt, Louis Hyatt, and Melvin Hyatt, and their respective spouses ("Applicants"), filed an Application for Notice of Change In Control ("Notice") in April 2001 pursuant to 12 CFR Section 574.3(b). The Notice permitted the Applicants to acquire up to 32.32% of Bancorp's issued and outstanding shares of stock of Bancorp by April 16, 2002. The OTS approved requests by the Applicants to extend the time to consummate such acquisition of shares to December 16, 2011. The Applicants have a further extension pending review by the Federal Reserve. The Applicants currently own approximately 29.63% of the total outstanding shares of Bancorp as of December 31, 2011.

The FRB is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and (ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisitions. The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

**Federal Securities Law.** Bancorp's securities are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. As such, Bancorp is subject to the information, proxy solicitation, insider trading, and other requirements and restrictions of the Securities Exchange Act of 1934.

**Financial Services Modernization Legislation.** In November 1999, the Gramm-Leach-Bliley Act of 1999 ("GLBA") was enacted. The GLBA generally permits banks, other depository institutions, insurance companies and securities firms to enter into combinations that result in a single financial services organization to offer customers a wider array of financial services and products provided that they do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The GLBA resulted in increased competition for Bancorp and the Bank from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than Bancorp and the Bank.

**Troubled Assets Relief Program.** During the fourth quarter of 2008, the U.S. Department of the Treasury (the "Treasury") instituted the Troubled Assets Relief Program (the "TARP") pursuant to the Emergency Economic Stabilization Act of 2008 (the "EESA") in an effort to stabilize the nation's capital markets. To carry out the TARP, the Treasury established the Capital Purchase Program (the "CPP") which financial institutions may participate in on a voluntary basis.

Bancorp elected to participate in the CPP and entered into agreements to sell certain securities to the Treasury on November 21, 2008 (the "CPP Agreements"). As a result of, and condition to, the CPP Agreements, Bancorp is subject to certain restrictions, requirements and limitations related to executive compensation, dividend payments and stock repurchase activities.

The American Recovery and Reinvestment Act of 2009 ("ARRA") and the regulations adopted thereunder have imposed additional compensation restrictions on companies participating in the TARP. As directed by ARRA, the Department of the Treasury has adopted standards for executive compensation that include limits on compensation that exclude incentives to take unnecessary and excessive risks that threaten the value of the participant, provision for recovery by the participant of any bonus, retention award or incentive compensation paid to any senior executive officer and up to 20 next mostly highly compensated employees of the participant based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate, and prohibitions on bonus, retention awards or incentive compensation to certain senior employees, among other provisions. TARP participants are required to annually allow shareholders to have a separate non-binding vote on executive compensation while a TARP investment is outstanding.

**Maryland Corporation Law.** Bancorp is incorporated under the laws of the State of Maryland, and is therefore subject to regulation by the state of Maryland. The rights of Bancorp's stockholders are governed by the Maryland General Corporation Law.

### ***Regulation of the Bank***

**General.** As noted above, the Dodd-Frank Act transferred supervision of savings associations like the Bank to the OCC, the agency that regulates national banks, on July 21, 2011. As a federally chartered, DIF-insured savings association, the Bank is subject to extensive regulation by the OCC and the FDIC. Lending activities and other investments of the Bank must comply with various statutory and regulatory requirements. The Bank is also subject to certain reserve requirements promulgated by the FRB. The OCC, in conjunction with the FDIC, regularly examines the Bank and prepares reports for the consideration of the Bank's Board of Directors on any deficiencies found in the operations of the Bank. The relationship between the Bank and depositors and borrowers is also regulated by federal and state laws, especially in such matters as the ownership of savings accounts and the form and content of mortgage documents utilized by the Bank.

The Bank must file reports with the OCC and the FDIC concerning its activities and financial condition, in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with or acquisitions of other financial institutions

**Regulatory Capital Requirements.** OCC regulations require the Bank to maintain minimum levels of regulatory capital including: (i) tangible capital equal to at least 1.5% of adjusted total assets; (ii) a leverage ratio consisting of Tier I or "core" capital equal to at least 4% (or 3%, if the Bank receives the highest CAMELS rating under the Uniform Financial Institutions Rating System) of adjusted total assets; and (iii) risk-based capital equal to at least 8% of total risk-weighted assets.

Tier I, or core capital includes common stockholder's equity (including retained earnings), non-cumulative perpetual preferred stock and related surplus, minority interests in the equity accounts of consolidated subsidiaries and certain non-withdrawable accounts or pledged deposits. Tier I (Core) capital is generally reduced by the amount of the saving's institution's intangible assets. Limited exceptions to the deduction of intangible assets exist for certain mortgage servicing rights and credit card relationships and qualifying supervisory goodwill.

Tangible capital is generally defined the same as core capital but does not include an exception for qualifying supervisory goodwill and is reduced by the amount of all the savings association's intangible assets with only limited exceptions, including certain mortgage servicing rights. Both core and tangible capital are further reduced by an amount equal to a savings institution's debt and equity investments in subsidiaries engaged in activities not permissible for national banks (other than subsidiaries engaged in activities undertaken as agent for customers or in mortgage banking activities and subsidiary depository institutions or their holding companies). Investments in and extensions of credit to such subsidiaries are required to be fully netted against tangible and core capital. At December 31, 2011, the Bank had no such investments.

Total capital equals the sum of Tier I (Core) capital and supplementary capital, to the extent that supplementary capital does not exceed Tier I (Core) capital. Supplementary capital includes, among other items, cumulative perpetual preferred stock, long-term preferred stock, subordinated debt, mandatory convertible securities, intermediate-term preferred stock, the portion of allowance for loan losses not designated for specific loan losses (up to 1.25% of risk-weighted assets) and up to 45% of unrealized gains on available-for-sale equity securities.

A savings institution's risk based capital requirement is measured against risk-weighted assets, which equal the sum of each on-balance sheet asset and the credit-equivalent amount of each off-balance-sheet item after each is multiplied by an assigned risk weight. These risk weights range from 0% for cash to 100% for consumer or commercial loans, home equity loans, repossessed assets or assets that are more than 90 days past due.



In addition to requiring institutions to meet the applicable capital standards for savings institutions, the OCC may require institutions to meet capital standards in excess of the prescribed standards as the OCC determines necessary or appropriate for such institution in light of the particular circumstances of the institution. Such circumstances would include a high degree of exposure to interest rate risk, concentration of credit risk and certain risks arising from non-traditional activity. The OCC may treat the failure of any savings institution to maintain capital at or above such level as an unsafe or unsound practice and may issue a directive requiring any savings institution which fails to maintain capital at or above the minimum level required by the OCC to submit and adhere to a plan for increasing capital.

As shown below, the Bank's regulatory capital exceeded all minimum regulatory capital requirements applicable to it as of December 31, 2011.

	Amount	Actual %	Required For Capital Adequacy Purposes Amount	%	Required To Be Well Capitalized Under Prompt Corrective Action Provisions Amount	%
	(dollars in thousands)					
<u>December 31, 2011</u>						
Tangible (1)	\$115,224	13.0%	\$13,345	1.50%	N/A	N/A
Tier I capital (2)	115,224	17.1%	N/A	N/A	\$40,292	6.00%
Core (1)	115,224	13.0%	35,586	4.00%	44,482	5.00%
Total (2)	123,626	18.4%	53,723	8.00%	67,154	10.00%
<u>December 31, 2010</u>						
Tangible (1)	\$117,733	12.3%	\$14,340	1.50%	N/A	N/A
Tier I capital (2)	117,733	15.6%	N/A	N/A	\$45,342	6.00%
Core (1)	117,733	12.3%	38,240	4.00%	47,800	5.00%
Total (2)	127,175	16.8%	60,456	8.00%	75,570	10.00%

(1) To adjusted total assets.

(2) To risk-weighted assets.

**Enforcement.** The OCC has primary enforcement responsibility over federal savings institutions and has the authority to bring enforcement action against the institution and all "institution-affiliated parties," including stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement actions by the OCC may range from issuance of a capital directive or cease and desist order, to removal of officers or directors of the institution and the appointment of a receiver or conservator. The FDIC also has the authority to terminate deposit insurance or recommend to the director of the OCC that enforcement action be taken with respect to a particular savings institution. If action is not taken by the director of the OCC, the FDIC has authority to take action under specific circumstances.

**Safety and Soundness Standards.** Federal law requires each federal banking agency, including the OCC, to prescribe to certain standards relating to internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, fees and benefits. In general, the guidelines require, among other things, appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. The guidelines further provide that savings institutions should maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or that could lead to material financial loss, and should take into account factors such as comparable compensation practices at comparable institutions. If the OCC determines that a savings institution is not in compliance with the safety and soundness guidelines, it may require the institution to submit an acceptable plan to achieve compliance with the guidelines. A savings institution must submit an acceptable compliance plan to the OCC within 30 days of receipt of a request for such a plan. If the institution fails to submit an acceptable plan, the OCC must issue an order directing the institution to correct the deficiency. Failure to submit or implement a compliance plan may subject the institution to regulatory sanctions.

**Prompt Corrective Action.** Under the prompt corrective action regulations, the OCC is required and authorized to take supervisory actions against undercapitalized savings associations. The leverage ratio, risk-based capital ratio and total risk-based capital ratio are used to determine an institution's capital classification. For this purpose, a savings association is placed into one of the following five categories dependent on their respective capital ratios:

- “well capitalized” (at least 5% leverage ratio, 6% Tier I risk-based capital ratio and 10% total risk-based capital ratio);
- “adequately capitalized” (at least 4% leverage ratio (or 3% if the savings association is assigned a composite rating of 1), 4% Tier I risk-based capital ratio and 8% total risk-based capital ratio);
- “undercapitalized” (less than 4% leverage ratio (or 3% if the savings association is assigned a composite rating of 1), 4% Tier I risk-based capital ratio or 8% total risk-based capital ratio);
- “significantly undercapitalized” (less than 3% leverage ratio, 3% Tier I risk-based capital ratio or 6% total risk-based capital ratio); and
- “critically undercapitalized” (less than 2% ratio of tangible equity to total assets).

Generally, the Federal Deposit Insurance Act requires the OCC to appoint a receiver or conservator for an institution within 90 days of that institution becoming “critically undercapitalized”. The regulation also provides that a capital restoration plan must be filed with the OCC within 45 days of the date an institution receives notice that it is “undercapitalized”, “significantly undercapitalized” or “critically undercapitalized”. In addition, numerous mandatory supervisory actions become immediately applicable to the institution, including, but not limited to, restrictions on growth, investment activities, payment of dividends and other capital distributions, and affiliate transactions. The OCC may also take any one of a number of discretionary supervisory actions against the undercapitalized institutions, including the issuance of a capital directive and, in the case of an institution that fails to file a required capital restoration plan, the replacement of senior executive officers and directors.

As of December 31, 2011, the Bank met the capital requirements of a “well capitalized” institution under applicable OCC regulations.

**Premiums for Deposit Insurance.** The Bank's deposits are insured up to applicable limits by the DIF of the FDIC and are backed by the full faith and credit of the United States government.

The FDIC regulations assess insurance premiums based on an institution's risk. Under this assessment system, the FDIC evaluates the risk of each financial institution based on its supervisory rating, financial ratios, and long-term debt issuer rating. In 2010, the assessment ranged from 7 to 77.5 basis points of an institution's deposits, depending on its risk category. On February 7, 2011, the FDIC issued final rules, effective April 1, 2011, implementing changes to the assessment rules as mandated by the Dodd-Frank Act. The final rules redefined the assessment base used for calculating deposit insurance assessments. Specifically, the rules base assessments on an institution's total assets less tangible capital, as opposed to total deposits. The base assessment rates range from 2.5 to 9 basis points for the least risky institutions to 30 to 45 basis points for the riskiest. The rate schedules will automatically adjust in the future as the DIF reaches certain milestones.

On May 22, 2009, the FDIC adopted a final rule imposing a 5 basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009. The amount of the special assessment for any institution was limited to 10 basis points times the institution's assessment base for the second quarter 2009, payable on September 30, 2009. On November 12, 2009, the FDIC amended its regulations to require insured institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012. For purposes of determining the prepayment, the FDIC used the institution's assessment rate in effect on September 30, 2009. The prepayment amount for the Bank was approximately \$5,838,000.

As discussed above, the Dodd-Frank Act made permanent the maximum deposit insurance amount of \$250,000 per depositor, and non-interest-bearing transaction accounts have unlimited deposit insurance through December 31, 2012.

The FDIC is authorized to terminate a depository institution's deposit insurance upon a finding by the FDIC that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution's regulatory agency. The termination of deposit insurance for the Bank could have a material adverse effect on Bancorp's earnings, depending on the collective size of the particular institutions involved.

All FDIC-insured depository institutions pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the Federal Housing Finance Board. The bonds, commonly referred to as Financing Corporation ("FICO") bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. For the quarter ended September 30, 2011, the annualized FICO assessment rate equaled 1.0 basis point for each \$100 in domestic deposits maintained at an institution. Beginning with the fourth quarter of 2011, the FICO assessment was based on total assets less tangible capital instead of deposits. The fourth quarter 2011 FICO assessment rate was 0.68 basis points and the first quarter 2012 FICO assessment rate was 0.66 basis points. FICO assessments will continue until the bonds mature in 2017 through 2019.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses of the Bank.

**Privacy.** Federal banking rules limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to these rules, financial institutions must provide:

- initial and annual notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates; and
- a reasonable method for customers to "opt out" of disclosures to nonaffiliated third parties.

Since the GLBA's enactment, a number of states have implemented their own versions of privacy laws. The Bank has implemented its privacy policies in accordance with applicable law.

**Loans-to-One Borrower Limitations.** With certain limited exceptions, the maximum amount that a savings association or a national bank may lend on an unsecured basis to any borrower (including certain related entities of the borrower) may not exceed 15% of the unimpaired capital and surplus of the institution, plus an additional 10% of unimpaired capital and surplus for loans fully secured by readily marketable collateral.

At December 31, 2011, the Bank's loans-to-one-borrower limit was \$17,284,000 based upon the 15% of unimpaired capital and surplus measurement. At December 31, 2011, the Bank's three largest loans were a \$7,045,000 loan secured by residential lots in Davidsonville, Maryland, a \$6,889,000 loan secured by an office building located in Annapolis, Maryland and a \$5,700,000 loan secured by commercial residential property located in Norfolk, Virginia. These loans were performing in accordance with their terms.

**Qualified Thrift Lender Test.** Savings associations must meet a QTL test, which test may be met either by maintaining, on average, at least 65% of its portfolio assets in qualified thrift investments in at least nine of the most recent twelve month period, or meeting the definition of a "domestic building and loan association" as defined in the Code. "Portfolio Assets" generally means total assets of a savings institution, less the sum of (i) specified liquid assets up to 20% of total assets, (ii) goodwill and other intangible assets, and (iii) the value of property used in the conduct of the savings association's business. Qualified thrift investments are primarily residential mortgages and related investments, including certain mortgage-related securities. Associations that fail to meet the QTL test must either convert to a bank charter or operate under specified restrictions. As of December 31, 2011, the Bank was in compliance with its QTL requirement and met the definition of a domestic building and loan association.

**Affiliate Transactions.** Transactions between savings associations and any affiliate are governed by Sections 23A and 23B of the Federal Reserve Act as made applicable to savings associations by Section 11 of the Home Owners' Loan Act (HOLA). A savings association affiliate includes any company or entity which controls the savings institution or that is controlled by a company that controls the savings association. For example, the holding

company of a savings association and any companies which are controlled by such holding company are affiliates of the savings association. Generally, Section 23A limits the extent to which the savings association or its subsidiaries may engage in “covered transactions” with any one affiliate to an amount equal to 10% of such association’s capital stock and surplus, as well as contains an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus. Section 23B applies to “covered transactions,” as well as certain other transactions and requires that all transactions be on terms substantially the same, or at least as favorable, to the savings association as those provided to a non-affiliate. “Covered transaction” include the making of loans to, purchase of assets from and issuance of a guarantee to an affiliate and similar transactions. Section 23B transactions also include the provision of services and the sale of assets by a savings association to an affiliate. In addition to the restrictions imposed by Sections 23A and 23B, Section 11 of the Home Owners’ Loan Act prohibits a savings association from (i) making a loan or other extension of credit to an affiliate, except for any affiliate which engages only in certain activities which are permissible for bank holding companies, or (ii) purchasing or investing in any stocks, bonds, debentures, notes or similar obligations of any affiliate, except for affiliates which are subsidiaries of the savings association.

The Bank’s authority to extend credit to executive officers, directors, trustees and 10% stockholders, as well as entities under such person’s control, is currently governed by Section 22(g) and 22(h) of the Federal Reserve Act and Regulation O promulgated by the FRB. Among other things, these regulations generally require such loans to be made on terms substantially similar to those offered to unaffiliated individuals, place limits on the amounts of the loans the Bank may make to such persons based, in part, on the Bank’s capital position, and require certain board of directors’ approval procedures to be followed.

**Capital Distribution Limitations.** OCC regulations impose limitations upon all capital distributions by savings associations, such as cash dividends, payments to repurchase or otherwise acquire its shares, payments to shareholders of another institution in a cash-out merger and other distributions charged against capital.

The OCC regulations require a savings association to file an application for approval of a capital distribution if:

- the association is not eligible for expedited treatment of its filings with the OCC;
- the total amount of all of capital distributions, including the proposed capital distribution, for the applicable calendar year exceeds its net income for that year to date plus retained net income for the preceding two years;
- the association would not be at least adequately capitalized following the distribution; or
- the proposed capital distribution would violate any applicable statute, regulation, agreement between the association and the OCC or OTS, or an OCC or OTS imposed condition.

In addition, a savings association must give the OCC notice of a capital distribution if the savings association is not required to file an application, but:

- would not be well capitalized following the distribution;
- the proposed capital distribution would reduce the amount of or retire any part of the savings association's common or preferred stock or retire any part of debt instruments like notes or debentures included in capital, other than regular payments required under a debt instrument; or
- the savings association is a subsidiary of a savings and loan holding company and is not otherwise required to file a notice regarding the proposed distribution with the Federal Reserve, in which case an information copy of the notice filed with the Federal Reserve needs to be simultaneously provided to the OCC.

The OCC may prohibit a proposed capital distribution that would otherwise be permitted if the OCC determines that the distribution would constitute an unsafe or unsound practice. In addition, the Federal Deposit Insurance Act provides that an insured depository institution shall not make any capital distribution, if after making such distribution the institution would be undercapitalized.

**Branching.** Under OCC branching regulations, the Bank is generally authorized to open branches within or beyond the State of Maryland if the Bank (1) qualifies as a “domestic building and loan association” under the Code, which qualification requirements are similar to those for a Qualified Thrift Lender under the Home Owners’ Loan Act, and (2) publishes public notice at least 30 days before opening a branch and no one opposes the branch. If a comment in opposition to a branch opening is filed and the OCC determines the comment to be relevant to the approval process standards, and to require action in response, the OCC may, among other things, require a branch application or elect to hold a meeting with the Bank and the person who submitted the comment. The OCC authority preempts any state law purporting to regulate branching by federal savings banks.

**Community Reinvestment Act and the Fair Lending Laws.** Savings associations have a responsibility under the Community Reinvestment Act and related regulations of the OCC to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. An institution's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities and the denial of applications. In addition, an institution's failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in the OCC, other federal regulatory agencies as well as the Department of Justice taking enforcement actions. Based on an examination conducted March 23, 2009, the Bank received a satisfactory rating.

**Federal Home Loan Bank System.** The Bank is a member of the FHLB-Atlanta. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB.

Under the capital plan of the FHLB-Atlanta as of December 31, 2011, the Bank was required to own at least \$6,943,000 of the capital stock of the FHLB-Atlanta. As of such date, the Bank owned \$6,943,000 of the capital stock of the FHLB-Atlanta and was in compliance with the capital plan requirements.

**Federal Reserve System.** The FRB requires all depository institutions to maintain non-interest bearing reserves at specified levels against their transaction accounts (primarily checking, NOW, and Super NOW checking accounts) and non-personal time deposits. At December 31, 2011, the Bank was in compliance with these requirements.

**Activities of Subsidiaries.** A savings association seeking to establish a new subsidiary, acquire control of an existing company or conduct a new activity through a subsidiary must provide 30 days prior notice to the FDIC and the FRB and conduct any activities of the subsidiary in compliance with regulations and orders of the FRB. The FRB has the power to require a savings association to divest any subsidiary or terminate any activity conducted by a subsidiary that the FRB determines to pose a serious threat to the financial safety, soundness or stability of the savings association or to be otherwise inconsistent with sound banking practices.

**Tying Arrangements.** Federal savings associations are prohibited, subject to some exceptions, from extending credit to or offering any other services, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

## **Item 1A. Risk Factors**

Unless the context indicates otherwise, all references to “we,” “us,” “our” in this subsection “Risk Factors” refer to Bancorp and its subsidiaries. You should carefully consider the risks and uncertainties described below as well as elsewhere in this Annual Report on Form 10-K. If any of the risks or uncertainties actually occurs, our business, financial condition or results of future operations could be materially adversely affected. The risks and uncertainties described in this Form 10-K are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently deem immaterial, also may become important factors that affect us. This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties. Our actual

results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by us described below and elsewhere in this Annual Report on Form 10-K.

**We may be adversely affected by changes in economic and political conditions and by governmental monetary and fiscal policies.**

The thrift industry is affected, directly and indirectly, by local, domestic, and international economic and political conditions, and by governmental monetary and fiscal policies. Conditions such as inflation, recession, unemployment, volatile interest rates, tight money supply, real estate values, international conflicts and other factors beyond our control may adversely affect our potential profitability. Any future rises in interest rates, while increasing the income yield on our earning assets, may adversely affect loan demand and the cost of funds and, consequently, our profitability. Any future decreases in interest rates may adversely affect our profitability because such decreases may reduce the amounts that we may earn on our assets. Economic downturns have resulted and may continue to result in the delinquency of outstanding loans. We do not expect any one particular factor to materially affect our results of operations. However, downtrends in several areas, including real estate, construction and consumer spending, have had and may continue to have a material adverse impact on our ability to remain profitable. Further, there can be no assurance that the asset values of the loans included in our loan portfolio, the value of properties and other collateral securing such loans, or the value of foreclosed real estate will remain at current levels.

**The changing economic environment poses significant challenges for Bancorp.**

Negative developments in the financial services industry from 2008 into 2011 have resulted in uncertainty in the financial markets in general and a related general economic downturn globally. While we are beginning to experience modest improvement in performance, we may experience similar negative conditions in 2012. In addition, as a consequence of the United States recession, business activity across a wide range of industries face serious difficulties due to the decline in the housing market and lack of consumer spending. Unemployment continues to be higher than historical averages.

As a result of these financial economic crises, many lending institutions, including us, have experienced declines in the performance of their loans, including residential, construction, land and residential building lots, multi-family, commercial and consumer loans. Moreover, competition among depository institutions for deposits and quality loans has increased significantly while the significant decline in economic growth has led to a slowdown in banking related activities. In addition, the values of real estate collateral supporting many commercial loans and home mortgages have declined and may continue to decline. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial services industry.

As a result, there is a potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be very aggressive in responding to concerns and trends identified in examinations, including the expected issuance of many formal or informal enforcement actions or orders. The impact of new legislation in response to those developments may negatively impact our operations by restricting our business operations, including our ability to originate or sell loans, and adversely impact our financial performance or our stock price.

We are operating in a challenging economic environment, including generally uncertain national and local market conditions. Negative market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses. Continued declines in real estate values, home sales volumes and financial stress on borrowers as a result of the uncertain economic environment, including job losses and other factors, could have adverse effects on our borrowers, which could adversely affect our financial condition and results of operations. For instance, because payments on loans secured by commercial real estate properties are often dependent upon the successful operation of management of the properties, repayment of these loans are subject to adverse conditions in the economy. As consumer spending decreases, businesses located in commercial real estate property may close, reducing the rental income of the Bank's borrower. The reduction in rental income may result in the borrower being unable to make payments on the loan. The deterioration in economic conditions could drive losses beyond that which is provided for in our allowance for loan losses and could result in the following:

- an increase in loan delinquencies, problem assets and foreclosures;
- a decline in demand for our products and services;
- a decrease in low cost or non-interest-bearing deposits; and
- a decline in the value of the collateral for our loans, which in turn may reduce customers' borrowing capacities, and reduce the value of assets and collateral supporting our existing loans.

During the past year, we continued to experience higher than normal levels of non-performing loans. No assurance can be given that these conditions will improve in the near term or will not worsen. Moreover, such conditions may result in a further increase in loan delinquencies, causing a decrease in our interest income, and may continue to have an adverse impact on our loan loss experience, possibly requiring us to add to our allowance for loan losses. Until conditions improve, we expect our business, financial condition and results of operations to be adversely affected.

**Changes in interest rates could adversely affect our financial condition and results of operations.**

The operations of financial institutions, such as ours, are dependent to a large degree on net interest income, which is the difference between interest income from loans and investments and interest expense on deposits and borrowings. Our net interest income is significantly affected by market rates of interest that in turn are affected by prevailing economic conditions, fiscal and monetary policies of the federal government and the policies of various regulatory agencies. Like all financial institutions, our balance sheet is affected by fluctuations in interest rates. Volatility in interest rates can also result in disintermediation, which is the flow of funds away from financial institutions into direct investments, such as U.S. Government bonds, corporate securities and other investment vehicles, including mutual funds, which, because of the absence of federal insurance premiums and reserve requirements, generally pay higher rates of return than those offered by financial institutions such as ours.

We expect to experience continual competition for deposit accounts which may make it difficult to reduce the interest paid on some deposits.

We believe that, in the current market environment, we have adequate policies and procedures for maintaining a conservative interest rate sensitive position. However, there is no assurance that this condition will continue. A sharp movement up or down in deposit rates, loan rates, investment fund rates and other interest-sensitive instruments on our balance sheet could have a significant, adverse impact on our net interest income and operating results.

**Most of our loans are secured by real estate located in our market area. If there is a continuing downturn in the real estate market, additional borrowers may default on their loans and we may not be able to fully recover our loans.**

A continuing downturn in the real estate market could adversely affect our business because most of our loans are secured by real estate. Substantially all of our real estate collateral is located in the states of Maryland, Virginia and Delaware. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other governmental statutes, regulations and policies and acts of nature.

In addition to the risks generally present with respect to mortgage lending activities, our operations are affected by other factors affecting our borrowers, including:

- the ability of our mortgagors to make mortgage payments,
- the ability of our borrowers to attract and retain buyers or tenants, which may in turn be affected by local conditions such as an oversupply of space or a reduction in demand for rental space in the area, the attractiveness of properties to buyers and tenants, and competition from other available space, or by the ability of the owner to pay leasing commissions, provide adequate maintenance and insurance, pay tenant improvements costs and make other tenant concessions,
- interest rate levels and the availability of credit to refinance loans at or prior to maturity, and

- increased operating costs, including energy costs, real estate taxes and costs of compliance with environmental controls and regulations.

As of December 31, 2011, approximately 99% of the book value of our loan portfolio consisted of loans collateralized by various types of real estate. If real estate prices decline, the value of real estate collateral securing our loans will be reduced. Our ability to recover defaulted loans by foreclosing and selling the real estate collateral would then be diminished, and we would be more likely to incur financial losses on defaulted loans.

In addition, approximately 49% of the book value of our loans consisted of construction, land acquisition and development loans, commercial real estate loans and land loans, which present additional risks described in “Item 1. Business - Construction Loans” of this Form 10-K.

### **Our loan portfolio exhibits a high degree of risk.**

We have a significant amount of nonresidential loans, as well as construction and land loans granted on a speculative basis. Although permanent single-family, owner-occupied loans represent the largest single component of assets and currently impaired loans, a significant level of nonresidential loans, construction loans, and land loans, results in an above-average risk exposure. Our monitoring of higher risk loans may be inadequate and the internal asset review function may be inadequate in view of current real estate market weaknesses.

At December 31, 2011 and December 31, 2010, our nonperforming loans (those loans 90 or more days in arrears) equaled \$31.4 million and \$46.2 million, respectively. There were 53 residential loans (including acquisition and development and land loans) in non-accrual status totaling \$27.0 million, ten commercial loans in non-accrual status totaling \$4.2 million, and four consumer loans in non-accrual status totaling \$0.2 million at December 31, 2011 compared to 86 residential loans in non-accrual status totaling \$39.9 million, 14 commercial loans in non-accrual status totaling \$6.2 million and two consumer loans in non-accrual status totaling \$26,000 at December 31, 2010. For the years ended December 31, 2011 and December 31, 2010, there were \$8.5 million and \$10.7 million of loan charge-offs, respectively. At December 31, 2011, the total allowance for loan losses was \$25.9 million, which was 3.72% of total net loans, compared with \$29.9 million, which was 3.82% of total net loans, as of December 31, 2010.

### **We are exposed to risk of environmental liabilities with respect to properties to which we take title.**

In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we become subject to significant environmental liabilities, our business, financial condition, results of operations and cash flows could be materially and adversely affected.

### **Our operations are located in Anne Arundel County, Maryland, which makes our business highly susceptible to local economic conditions. An economic downturn or recession in this area may adversely affect our ability to operate profitably.**

Unlike larger banking organizations that are geographically diversified, our operations are concentrated in Anne Arundel County, Maryland. In addition, nearly all of our loans have been made to borrowers in the states of Maryland, Virginia and Delaware. As a result of this geographic concentration, our financial results depend largely upon economic conditions in our market area. A deterioration or recession in economic conditions in this market could result in one or more of the following:

- a decrease in deposits;



- an increase in loan delinquencies;
- an increase in problem assets and foreclosures;
- a decrease in the demand for our products and services; and
- a decrease in the value of collateral for loans, especially real estate, and reduction in customers' borrowing capacities.

Any of the foregoing factors may adversely affect our ability to operate profitably.

**Failure to comply with the Supervisory Agreements could adversely affect our business, financial condition and operating results.**

On November 23, 2009, we and the Bank each entered into a supervisory agreement with the OTS, which agreements primarily addressed issues identified in the OTS' reports of examination of our and the Bank's operations and financial condition conducted in 2009. These supervisory agreements are now being overseen by the OCC. Although we and the Bank each intend to take such actions as may be necessary to enable us to comply with our respective requirements, there can be no assurance that we will be able to comply fully with the provisions of the Supervisory Agreements, or to do so within the timeframes required. Moreover, there can be no assurance that compliance with such requirements will not be more time consuming or more expensive than anticipated, or that efforts to comply with such requirements will not have adverse effects on the operations and financial condition of us or the Bank. Failure to comply with the Supervisory Agreements, or other supervisory directives, could subject us to significant civil monetary penalties, orders to cease and desist or other regulatory or enforcement actions. Accordingly, any material failure to comply with the Supervisory Agreements could have a material adverse effect on our business, financial condition and operating results.

**We are subject to federal and state regulation and the monetary policies of the FRB. Such regulation and policies can have a material adverse effect on our earnings and prospects.**

Our operations are heavily regulated and will be affected by present and future legislation and by the policies established from time to time by various federal and state regulatory authorities. In particular, the monetary policies of the FRB have had a significant effect on the operating results of banks in the past, and are expected to continue to do so in the future. Among the instruments of monetary policy used by the FRB to implement its objectives are changes in the discount rate charged on bank borrowings and changes in the reserve requirements on bank deposits. It is not possible to predict what changes, if any, will be made to the monetary policies of the FRB or to existing federal and state legislation or the effect that such changes may have on our future business and earnings prospects.

If the Bank becomes "undercapitalized" as determined under the "prompt corrective action" initiatives of the federal bank regulators, such regulatory authorities will have the authority to require the Bank to, among other things, alter, reduce or terminate any activity that the regulator determines poses an excessive risk to the Bank. The Bank could further be directed to take any other action that the regulatory agency determines will better carry out the purpose of prompt corrective action. The Bank could be subject to these prompt corrective action restrictions if federal regulators determine that the Bank is in an unsafe or unsound condition or engaging in an unsafe or unsound practice. Some or all of the foregoing actions and restrictions could have a material adverse effect on our operations.

**The Dodd-Frank Act, which is still being implemented, may have a material impact on our operations.**

On July 21, 2010, the President signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Dodd-Frank Act restructures the regulation of depository institutions. Under the Dodd-Frank Act, the Office of Thrift Supervision was merged into the Office of the Comptroller of the Currency, which regulates national banks. Savings and loan holding companies are now regulated by the Federal Reserve. Also, included was the creation of a new federal agency to administer consumer protection and fair lending laws, a function that is now performed by the depository institution regulators. The federal preemption of state laws currently accorded federally chartered depository institutions was reduced as well. The Dodd-Frank Act

also will impose consolidated capital requirements on savings and loan holding companies effective in five years, which will limit our ability to borrow at the holding company and invest the proceeds from such borrowings as capital in the Bank that could be leveraged to support additional growth. The Dodd-Frank Act contains various other provisions designed to enhance the regulation of depository institutions and prevent the recurrence of a financial crisis such as occurred in 2008-2009. The full impact of the Dodd-Frank Act on our business and operations will not be known for years until all regulations implementing the statute are written, adopted and implemented. The Dodd-Frank Act may have a material impact on operations, particularly through increased regulatory burden and compliance costs.

**We have established an allowance for loan losses based on our management's estimates. Actual losses could differ significantly from those estimates. If the allowance is not adequate, it could have a material adverse effect on our earnings and the price of our common stock.**

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, that represents management's best estimate of probable incurred losses within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of specific credit risks; loan loss experience; current loan portfolio quality; present economic, political and regulatory conditions; industry concentrations and other unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and judgment and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. Increases in nonperforming loans have a significant impact on our allowance for loan losses. Generally, our non-performing loans and assets reflect operating difficulties of individual borrowers resulting from weakness in the economy of our market area. While Bancorp is experiencing better performance results from those experienced in 2009 and 2008, loan delinquencies remain higher than usual, particularly with respect to residential construction, land and residential building lots, multi-family, commercial and consumer loans. Bancorp has seen a decrease in troubled debt restructurings balances in 2011 compared to 2010, although the balances are still high compared to historical averages.

In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. If charge-offs in future periods exceed the allowance for loan losses, we will need additional provisions to increase the allowance for loan losses. Furthermore, growth in the loan portfolio would generally lead to an increase in the provision for loan losses.

Any increases in the allowance for loan losses will result in a decrease in net income and capital, and may have a material adverse effect on our financial condition, results of operations and cash flows.

**We compete with a number of local, regional and national financial institutions for customers.**

We face strong competition from savings and loan associations, banks, and other financial institutions that have branch offices or otherwise operate in our market area, as well as many other companies now offering a range of financial services. Many of these competitors have substantially greater financial resources and larger branch systems than us. In addition, many of our competitors have higher legal lending limits than us. Particularly intense competition exists for sources of funds including savings and retail time deposits as well as for loans and other services offered by us. In addition, over the last several years, the banking industry has undergone substantial consolidation, and this trend is expected to continue. Significant ongoing consolidation in the banking industry may result in one or more large competitors emerging in our primary target market. The financial resources, human capital and expertise of one or more large institutions could threaten our ability to maintain our competitiveness.

During the past several years, significant legislative attention has been focused on the regulation and deregulation of the financial services industry. Non-bank financial institutions, such as securities brokerage firms, insurance companies and mutual funds, have been permitted to engage in activities that compete directly with

traditional bank business. Competition with various financial institutions could hinder our ability to maintain profitable operations and grow our business.

**We face intense competitive pressure on customer pricing, which may materially and adversely affect revenues and profitability.**

We generate net interest income, and charge our customers fees, based on prevailing market conditions for deposits, loans and other financial services. In order to increase deposit, loan and other service volumes, enter new market segments and expand our base of customers and the size of individual relationships, we must provide competitive pricing for such products and services. In order to stay competitive, we have had to intensify our efforts around attractively pricing our products and services. To the extent that we must continue to adjust our pricing to stay competitive, we will need to grow our volumes and balances in order to offset the effects of declining net interest income and fee-based margins. Increased pricing pressure also enhances the importance of cost containment and productivity initiatives, and we may not succeed in these efforts.

**Our brand, reputation and relationship with our customers are key assets of our business and may be affected by how we are perceived in the marketplace.**

Our brand and its attributes are key assets of our business. The ability to attract and retain customers to Bancorp's products and services is highly dependent upon the external perceptions of us and the industry in which we operate. Our business may be affected by actions taken by competitors, customers, third party providers, employees, regulators, suppliers or others that impact the perception of the brand, such as creditor practices that may be viewed as "predatory," customer service quality issues, and employee relations issues. Adverse developments with respect to our industry may also, by association, impair our reputation, or result in greater regulatory or legislative scrutiny.

**Our business is highly reliant on technology and our ability to manage the operational risks associated with technology.**

We rely heavily on communications and information systems to conduct our business. Our business involves storing and processing sensitive customer data. Any failure, interruption or breach in security of these systems could result in theft of customer data or failures or disruptions in our customer relationship management, general ledger, deposit, loan, data storage, processing and other systems. Our inability to access these information systems at critical points in time could unfavorably impact the timeliness and efficiency of our business operations. In addition, we operate a number of money transfer and related electronic, check and other payment connections that are vulnerable to individuals engaging in fraudulent activities that seek to compromise payments and related financial systems illegally. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, result in increased expense to contain the event and/or require that we provide credit monitoring services for affected customers or expose us to civil litigation and regulatory fines and sanctions, any of which could have a material adverse effect on our financial condition and results of operations.

**Our business is highly reliant on third party vendors and our ability to manage the operational risks associated with outsourcing those services.**

We rely on third parties to provide services that are integral to our operations. These vendors provide services that support our operations, including storage and processing of sensitive consumer data. A cyber security breach of a vendor's system may result in theft of our data or disruption of business processes. A material breach of customer data at a service provider's site may negatively impact our business reputation and cause a loss of customer business; result in increased expense to contain the event and/or require that we provide credit monitoring services for affected customers, result in regulatory fines and sanctions and may result in litigation. In most cases,

we will remain primarily liable to our customers for losses arising from a breach of a vendor's data security system. We rely on our outsourced service providers to implement and maintain prudent cyber security controls. We have procedures in place to assess a vendor's cyber security controls prior to establishing a contractual relationship and to periodically review assessments of those control systems; however, these procedures are not infallible and a vendor's system can be breached despite the procedures we employ.

If our third party providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure you that we would be able to negotiate terms that are as favorable to us, or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all.

**We continually encounter technological change, and, if we are unable to develop and implement efficient and customer friendly technology, we could lose business.**

The financial services industry is continually undergoing rapid technological change, with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to achieve additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

**Our success depends on our senior management team, and if we are not able to retain our senior management team, it could have a material adverse effect on us.**

We are highly dependent upon the continued services and experience of our senior management team, including Alan J. Hyatt, our Chairman, President and Chief Executive Officer. We depend on the services of Mr. Hyatt and the other members of our senior management team to, among other things, continue the development and implementation of our strategies, and maintain and develop our customer relationships. We do not have an employment agreement with members of our senior management, nor do we maintain "key-man" life insurance on our senior management. If we are unable to retain Mr. Hyatt and other members of our senior management team, our business could be materially and adversely affected.

**If we fail to maintain an effective system of internal control over financial reporting and disclosure controls and procedures, we may be unable to accurately report our financial results and comply with the reporting requirements under the Securities Exchange Act of 1934. As a result, current and potential stockholders may lose confidence in our financial reporting and disclosure required under the Securities Exchange Act of 1934, which could adversely affect our business and could subject us to regulatory scrutiny.**

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, referred to as Section 404, we are required to include in our Annual Reports on Form 10-K, our management's report on internal control over financial reporting. We are currently not required to include an opinion of our independent registered public accounting firm as to our internal controls because we are a "smaller reporting company" under SEC rules and, therefore, stockholders do not have the benefit of such an independent review of our internal controls. While we have reported no "material weaknesses" in the Form 10-K for the fiscal year ended December 31, 2011, we cannot guarantee that we will not have any "material weaknesses" in the future. Compliance with the requirements of Section 404 is expensive and time-consuming. If, in the future, we fail to complete this evaluation in a timely manner, or, if required, our independent registered public accounting firm cannot timely attest to our evaluation, we could be subject to regulatory scrutiny and a loss of public confidence in our internal control over financial reporting. In addition, any failure to maintain an effective system of disclosure controls and procedures could cause our current and potential

stockholders and customers to lose confidence in our financial reporting and disclosure required under the Securities Exchange Act of 1934, which could adversely affect our business.

**Terrorist attacks and threats or actual war may impact all aspects of our operations, revenues, costs and stock price in unpredictable ways.**

Terrorist attacks in the United States and abroad, as well as future events occurring in response to or in connection with them, including, without limitation, future terrorist attacks against U.S. targets, rumors or threats of war, actual conflicts involving the United States or its allies or military or trade disruptions, may impact our operations. Any of these events could cause consumer confidence and savings to decrease or could result in increased volatility in the United States and worldwide financial markets and economy. Any of these occurrences could have an adverse impact on our operating results, revenues and costs and may result in the volatility of the market price for our common stock and on the future price of our common stock.

**There can be no assurance that we will pay dividends in the future.**

The supervisory agreements with the Federal Reserve and OCC require, among other things, that Bancorp and the Bank obtain prior OCC approval before any dividends or capital distributions can be made and that Bancorp obtain prior Federal Reserve approval before purchasing or redeeming shares of its stock. In addition, Bancorp suspended its common stock dividend in the fourth quarter of 2009 to preserve its capital. Although we expect to be able to resume our policy of quarterly dividend payments, this dividend policy will be reviewed in light of future earnings, OCC restrictions and other considerations. No assurance can be given, therefore, that cash dividends on our common stock will be paid in the future.

**Our Series A preferred stock, Series B preferred stock and 2035 Debentures contain restrictions on our ability to declare and pay dividends on, or repurchase, our common stock.**

Our ability to declare dividends on our common stock is limited by the terms of our Series A preferred stock and Series B preferred stock. We may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to our common stock in any quarter until the dividend on the Series A Preferred Stock has been declared and paid for such quarter, subject to certain minor exceptions. Additionally, we may not declare or pay any dividend or distribution on our common stock, and we may not purchase, redeem or otherwise acquire for consideration any of our common stock, unless all accrued and unpaid dividends for all past dividend periods, including the latest completed dividend period, on all outstanding shares of Series B preferred stock have been or are contemporaneously declared and paid in full (or have been declared and a sum sufficient for the payment thereof has been set aside), subject to certain minor exceptions.

Additionally, under the terms of our 2035 Debentures, if (i) there has occurred and is continuing an event of default, (ii) we are in default with respect to payment of any obligations under the related guarantee or (iii) we have given notice of our election to defer payments of interest on the 2035 Debentures by extending the interest distribution period as provided in the indenture governing the 2035 Debentures and such period, or any extension thereof, has commenced and is continuing, then we may not, among other things, declare or pay any dividends or distributions on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of our capital stock, including our common stock.

**An investment in our securities is not insured against loss.**

Investments in our common stock, are not deposits insured against loss by the FDIC or any other entity. As a result, an investor may lose some or all of his, her or its investment.

**Conversion of our Series A preferred stock or exercise of the warrant issued to the Treasury Department will dilute the ownership interest of existing stockholders.**

In private placements conducted in November 2008, we issued Series A preferred stock convertible into 437,500 shares of our common stock, subject to adjustment, and a warrant to purchase 556,976 shares of our common stock, subject to adjustment. The conversion of some or all of the Series A preferred stock or the exercise of the warrant will dilute the ownership interest of existing stockholders. Any sales in the public market of the common stock issuable upon such conversion or exercise could adversely affect prevailing market prices of our common stock. In addition, the existence of the Series A preferred stock or warrant may encourage short selling by market participants because the conversion of the Series A preferred stock or exercise of the warrant could depress the price of our common stock.

**“Anti-takeover” provisions will make it more difficult for a third party to acquire control of us, even if the change in control would be beneficial to our equity holders.**

Our charter presently contains certain provisions that may be deemed to be “anti-takeover” and “anti-greenmail” in nature in that such provisions may deter, discourage or make more difficult the assumption of control of us by another corporation or person through a tender offer, merger, proxy contest or similar transaction or series of transactions. For example, currently, our charter provides that our Board of Directors may amend the charter, without stockholder approval, to increase or decrease the aggregate number of shares of our stock or the number of shares of any class that we have authority to issue. In addition, our charter provides for a classified Board, with each Board member serving a staggered three-year term. Directors may be removed only for cause and only with the approval of the holders of at least 75 percent of our common stock. The overall effects of the “anti-takeover” and “anti-greenmail” provisions may be to discourage, make more costly or more difficult, or prevent a future takeover offer, prevent stockholders from receiving a premium for their securities in a takeover offer, and enhance the possibility that a future bidder for control of us will be required to act through arms-length negotiation with our Board of Directors. These provisions may also have the effect of perpetuating incumbent management.

#### **Item 1B. Unresolved Staff Comments**

None

#### **Item 2. Properties**

HS constructed a building in Annapolis, Maryland that serves as Bancorp’s and the Bank’s administrative headquarters. A branch office of the Bank is also included in the building. Bancorp and the Bank lease their executive and administrative offices from HS. In addition, HS leases space to four unrelated companies and to a law firm in which the President of Bancorp and the Bank is a partner.

Bancorp has four retail branch locations in Anne Arundel County, Maryland, of which it owns three and leases the fourth from a third party. The initial lease term expired July 2010 and the first option to renew for an additional five year term was exercised. There is an option to renew the lease for one more additional five year term. In addition, the Bank leases office space in Annapolis, Maryland from a third party. The lease expires January 2016, with the option to renew the lease for one additional five year term.

#### **Item 3. Legal Proceedings**

There are no material pending legal proceedings to which Bancorp, the Bank or any subsidiary is a party or to which any of their property is subject.

#### **Item 4. Mine Safety Disclosures**

Not applicable.

#### **Item 4.1. Executive Officers of the Registrant**

Thomas G. Bevivino, age 56, joined Bancorp in August 2004 as Controller, and has served as the Chief Financial Officer since July 1, 2005. He serves in the same capacity for the Bank. Effective December 2011, Mr.

Bevivino was promoted to Chief Operating Officer of Bancorp and the Bank, subject to the approval of the Federal Reserve and the OCC which approval was received in February 2012. Mr. Bevivino continued to serve as Chief Financial Officer until a replacement was approved by regulators in February 2012. Mr. Bevivino was a financial consultant from 2002 until 2004, and served as Chief Financial Officer of Luminant Worldwide Corporation from 1999 until 2002.

Stephen W. Lilly was appointed as Chief Financial Officer of Bancorp in February 2012 upon receipt of regulatory approval. Mr. Lilly joined Bancorp in November 2011 as Senior Vice President. Prior to joining Bancorp, he served as Chief Financial Officer of Bay Vanguard FSB in Baltimore, Maryland.

Phillip V. Jones, Jr., age 60, joined Bancorp in July 2009 as Executive Vice President and Chief Operating Officer. Effective January 1, 2011, Mr. Jones shifted his role from Chief Operating Officer to Chief Relationship Officer. He will serve in the same capacity for the Bank. Mr. Jones served as Executive Vice President, National Commercial Real Estate for Sovereign Bank from 2003 to May 2009.

The biography of Alan J. Hyatt will be continued in the proxy statement for the 2012 Annual Meeting of Shareholders.

## **PART II**

### **Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The common stock of Bancorp is traded on the Nasdaq Capital Market under the symbol "SVBI". As of March 9, 2012, there were 1,368 stockholders of record of Bancorp's common stock.

Registrar and Transfer Company, 10 Commerce Drive, Cranford, New Jersey 07016-3572, serves as the Transfer Agent and Registrar for Bancorp.

The following table sets forth the high and low sales prices per share of Bancorp's common stock for the periods indicated, as reported on the Nasdaq Capital Market:

#### Quarterly Stock Information

2011				2010			
Quarter	Stock Price Range		Per Share Dividend	Quarter	Stock Price Range		Per Share Dividend
	Low	High			Low	High	
1 <sup>st</sup>	\$3.02	\$5.69	\$-	1 <sup>st</sup>	\$2.20	\$4.37	\$-
2 <sup>nd</sup>	3.07	4.99	-	2 <sup>nd</sup>	3.75	6.57	-
3 <sup>rd</sup>	2.09	3.66	-	3 <sup>rd</sup>	3.10	5.36	-
4 <sup>th</sup>	2.25	3.17	-	4 <sup>th</sup>	2.80	3.98	-

#### **Dividend Policy**

In November 2009, Bancorp and the Bank entered into supervisory agreements with the OTS, which require, among other things, that Bancorp and the Bank obtain prior OTS approval before any dividends or capital distributions can be made and that Bancorp obtain prior OTS approval before purchasing or redeeming shares of its stock. OTS regulations further limit the payment of dividends and other capital distributions by the Board.

Bancorp's main source of income is dividends from the Bank. As a result, Bancorp's dividends to its common shareholders now will depend primarily upon OCC and Federal Reserve approval and receipt of dividends from the Bank.

Bancorp suspended its common stock dividend in the fourth quarter of 2009 to preserve its capital.

Bancorp's ability to declare a dividend on its common stock is also limited by the terms of Bancorp's Series A preferred stock and Series B preferred stock. Bancorp may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to its common stock in any quarter until the dividend on the Series A preferred stock has been declared and paid for such quarter, subject to certain minor exceptions. Additionally, Bancorp may not declare or pay any dividend or distribution on its common stock, and Bancorp may not purchase, redeem or otherwise acquire for consideration any of its common stock, unless all accrued and unpaid dividends for all past dividend periods, including the latest completed dividend period, on all outstanding shares of Series B preferred stock have been or are contemporaneously declared and paid in full (or have been declared and a sum sufficient for the payment thereof has been set aside), subject to certain minor exceptions.

Additionally, under the terms of Bancorp's 2035 Debentures, if (i) there has occurred and is continuing an event of default, (ii) Bancorp is in default with respect to payment of any obligations under the related guarantee or (iii) Bancorp has given notice of its election to defer payments of interest on the 2035 Debentures by extending the interest distribution period as provided in the indenture governing the 2035 Debentures and such period, or any extension thereof, has commenced and is continuing, then Bancorp may not, among other things, declare or pay any dividends or distributions on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of its capital stock, including common stock.

#### **Item 6. Selected Financial Data**

For information concerning quarterly financial data for Bancorp, see Note 18 to the consolidated financial statements.

The following financial information is derived from the audited financial statements of Bancorp. The information is a summary and should be read in conjunction with Bancorp's audited financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations.

#### **Summary Financial and Other Data**

	At December 31,				
	2011	2010	2009	2008	2007
	(dollars in thousands, except per share information)				
Balance Sheet Data					
Total assets	\$ 900,628	\$ 962,543	\$ 967,788	\$ 987,651	\$ 962,234
Total loans, net	693,303	778,937	814,234	896,459	893,014
Investment securities held to maturity	40,357	27,311	8,031	1,345	2,383
Non-performing loans	31,432	46,164	60,808	54,795	7,700
Total non-performing assets	51,364	67,119	82,382	61,112	10,693
Deposits	652,757	714,776	710,329	683,866	652,773
Short-term borrowings	-	-	-	-	15,000
Long-term debt	115,000	115,000	125,000	153,000	175,000
Total liabilities	794,698	856,443	861,557	863,984	866,958
Stockholders' equity	105,930	106,100	106,231	123,667	95,276
Book value per common share	\$7.88	\$7.89	\$7.91	\$9.64	\$9.46
Common shares outstanding	10,066,679	10,066,679	10,066,679	10,066,679	10,066,679
Other Data:					
Number of:					
Full service retail banking facilities	4	4	4	4	4
Full-time equivalent employees	127	116	118	106	118



## Summary of Operations

	For the Year Ended December 31,				
	2011	2010	2009	2008	2007
	(dollars in thousands, except per share information)				
Interest income	\$44,501	\$49,533	\$52,658	\$62,472	\$71,814
Interest expense	15,587	19,329	26,051	33,503	38,176
Net interest income	28,914	30,204	26,607	28,969	33,638
Provision for loan losses	4,612	5,744	31,402	7,481	2,462
Net interest income (loss) after provision for loan losses	24,302	24,460	(4,795)	21,488	31,176
Non-interest income	2,510	2,745	2,501	2,791	4,336
Non-interest expense	24,611	25,008	22,862	17,293	16,492
Income (loss) before income tax provision (benefit)	2,201	2,197	(25,156)	6,986	19,020
Provision for income taxes (benefit)	982	1,040	(9,928)	2,873	7,909
Net income (loss)	\$1,219	\$1,157	\$(15,228)	\$4,113	\$11,111
Per Share Data:					
Basic earnings (loss) per share	\$(0.05)	\$(0.06)	\$(1.68)	\$0.39	\$1.10
Diluted earnings (loss) per share	\$(0.05)	\$(0.06)	\$(1.68)	\$0.39	\$1.10
Cash dividends declared per share	\$-	\$-	\$0.09	\$0.24	\$0.24
Weighted number of shares outstanding basic	10,066,679	10,066,679	10,066,679	10,066,679	10,066,283
Weighted number of shares outstanding diluted	10,066,679	10,066,679	10,066,679	10,066,679	10,066,283

### **Key Operating Ratios**

	For the Year Ended December 31,				
	2011	2010	2009	2008	2007
<b>Performance Ratios:</b>					
Return on average assets	0.13%	0.12%	(1.54%)	0.43%	1.19%
Return on average equity	1.15%	1.12%	(13.13%)	4.03%	12.09%
Dividend payout ratio	-%	-%	(5.36%)	61.54%	21.82%
Net interest margin	3.39%	3.40%	2.90%	3.16%	3.81%
Interest rate spread	3.34%	3.36%	2.64%	2.81%	3.45%
Non-interest expense to average assets	2.62%	2.56%	2.32%	1.79%	1.76%
Efficiency ratio*	61.11%	59.15%	61.77%	51.64%	42.82%
<b>Asset Quality Ratios:</b>					
Average equity to average assets	11.27%	10.59%	11.76%	10.55%	9.82%
Nonperforming assets to total assets at end of period	5.70%	6.97%	8.51%	6.19%	1.11%
Nonperforming loans to total gross loans at end of period	4.23%	5.50%	6.71%	5.63%	0.78%
Allowance for loan losses to net loans at end of period	3.72%	3.82%	4.24%	1.65%	1.21%
Allowance for loan losses to nonperforming loans at end of period	82.52%	64.71%	57.05%	27.03%	140.01%

\* The efficiency ratio is general and administrative expenses as a percentage of net interest income plus non-interest income.

### Average Balance Sheet

The following table contains for the periods indicated information regarding the total dollar amounts of interest income from interest-earning assets and the resulting average yields, the total dollar amount of interest expense on interest-bearing liabilities and the resulting average costs, net interest income, and the net yield on interest-earning assets.

	Year Ended December 31,					
	2011			2010		
	Average Volume	Interest	Yield/Cost	Average Volume	Interest	Yield/Cost
	(dollars in thousands)					
<b>ASSETS</b>						
Loans (1)	\$753,926	\$43,675	5.79%	\$823,410	\$49,154	5.97%
Investments (2)	36,501	584	1.60%	16,422	223	1.36%
Mortgage-backed securities	752	33	4.43%	1,022	22	2.15%
Other interest-earning assets (3)	62,003	209	0.34%	46,383	134	0.29%
Total interest-earning assets	853,182	44,501	5.22%	887,237	49,533	5.58%
Non-interest earning assets	85,712			90,240		
Total Assets	<u>\$938,894</u>			<u>\$977,477</u>		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Savings and checking deposits	\$284,808	1,894	0.66%	\$288,263	3,439	1.19%
Certificates of deposits	405,147	8,511	2.10%	434,144	10,296	2.37%
Borrowings	139,119	5,182	3.72%	147,311	5,594	3.80%
Total interest-bearing liabilities	829,074	15,587	1.88%	869,718	19,329	2.22%
Non-interest bearing liabilities	4,039			4,246		
Stockholders' equity	105,781			103,513		
Total liabilities and stockholders' equity	<u>\$938,894</u>			<u>\$977,477</u>		
Net interest income and interest rate spread	<u>\$28,914</u>		3.34%	<u>\$30,204</u>		3.36%
Net interest margin			3.39%			3.40%
Average interest-earning assets to average interest-bearing liabilities			102.91%			102.01%
					<u>\$26,607</u>	2.64%
						2.90%
						109.20%

(1) Non-accrual loans are included in the average balances and in the computation of yields.

(2) Bancorp does not have any tax-exempt investment securities.

(3) Other interest earning assets include interest bearing deposits in other banks, federal funds, and FHLB stock investments.

### Rate Volume Table

	Year ended December 31, 2011			Year ended December 31, 2010		
	vs.			vs.		
	Year ended December 31, 2010			Year ended December 31, 2009		
	Total	Changes Due to		Total	Changes Due to	
	Change	Volume (1)	Rate (1)	Change	Volume (1)	Rate (1)
(dollars in thousands)						
Interest-earning assets						
Loans	\$(5,479)	\$(4,148)	\$(1,331)	(\$3,366)	(\$3,276)	(\$90)
Investments	361	273	88	182	156	26
Mortgage-backed securities	11	(6)	17	(41)	(11)	(30)
Other interest-earning assets	75	45	30	100	11	89
Total interest income	(5,032)	(3,836)	(1,196)	(3,125)	(3,120)	(5)
Interest-bearing liabilities						
Savings and checking deposits	(1,783)	(47)	(1,736)	31	1,816	(1,785)
Certificates of deposits	(1,547)	(655)	(892)	(6,078)	(2,186)	(3,892)
Borrowings	(412)	(311)	(101)	(675)	297	(972)
Total interest expense	(3,742)	(1,013)	(2,729)	(6,722)	(73)	(6,649)
Net change in net interest income	<u>\$(1,290)</u>	<u>\$(2,823)</u>	<u>\$1,533</u>	<u>\$3,597</u>	<u>(\$3,047)</u>	<u>\$6,644</u>

(1) Changes in interest income/expense not arising from volume or rate variances are allocated proportionately to rate and volume.

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **Overview**

Bancorp provides a wide range of personal and commercial banking services. Personal services include various lending services as well as deposit products such as checking accounts, individual retirement accounts, money market accounts, and savings and time deposit accounts. Commercial services include commercial secured and unsecured lending services as well as business internet banking, corporate cash management services and deposit services. Bancorp also provides ATMs, debit cards, internet banking including on-line bill pay, mortgage lending, safe deposit boxes, and telephone banking, among other products and services.

Bancorp has experienced improved earnings from those experienced during the second half of 2008 and all of 2009 as it continues to see some improvement in the national and local economic environment. Management believes that Bancorp's 2011 and 2010 results, while significantly better than 2009, do not mean that it will not continue to experience the challenges it and many other financial institutions faced in 2008 and 2009 as a result of the economic recession. Those challenges, including increased loan delinquencies and a decrease in the demand for certain loan products including construction, development, and land acquisition loans, continue to show signs of improvement from 2008 and 2009. However, continued declines in real estate values, home sales volumes and financial stress on borrowers as a result of the recession, including job losses and other factors, have continued to affect Bancorp's borrowers. Management believes that this economic deterioration has continued to be stable in 2011 since having stabilized somewhat in 2010 which has resulted in stabilization in loan delinquencies from 2009 levels. While the interest rate spread between Bancorp's cost of funds and what it earns on loans has increased from 2009 levels, competition for new loans and deposits remains strong. The increase in interest rate spread was caused in part by decreases in non-accrual loans in which interest income was not recorded, and to decreases in interest rates paid on deposits and other borrowings outpacing the decreases in interest earned on loans.

Bancorp's total loan portfolio has decreased from 2010 and Bancorp has experienced a modest decrease in loan delinquencies, which resulted in the allowance for loan losses decreasing from 2010. Bancorp has seen the same level of foreclosed real estate expenses in 2011 as in 2010 due to loans going to foreclosure.

Bancorp expects to experience continued improvement in market conditions in 2012, as the effects of the recession continue to improve and as the employment environment in its market improves. However, if interest rates increase, demand for borrowing may remain low and Bancorp's interest rate spread could decrease. Bancorp will continue to manage loan and deposit pricing against the risks of rising costs of its deposits and borrowings. Interest rates are outside the control of Bancorp, so it must attempt to balance its pricing and duration of its loan portfolio against the risks of rising costs of its deposits and borrowings.

The continued success and attraction of Anne Arundel County, Maryland, and vicinity, will also be important to Bancorp's ability to originate and grow its mortgage loans and deposits, as will Bancorp's continued focus on maintaining a low overhead.

If the volatility in the market and the economy continues or worsens, our business, financial condition, results of operations, access to funds and the price of our stock could be materially and adversely impacted.

On November 23, 2009, Bancorp and the Bank each entered into a supervisory agreement with the OTS which primarily addressed the issues identified in the OTS' reports of examination of Bancorp's and the Bank's operations and financial condition in 2009. See "Item 1. Business – Supervisory Agreements" for more information.

### **Critical Accounting Policies**

Bancorp's significant accounting policies and recent accounting pronouncements are set forth in Note 1 of the consolidated financial statements for the year ended December 31, 2011 which are included elsewhere in this Form 10-K. Of these significant accounting policies, Bancorp considers the policies regarding the allowance for loan losses and valuation of foreclosed real estate to be its most critical accounting policies, given the uncertainty in evaluating the level of the allowance required to cover credit losses inherent in the loan portfolio and the material effect that such judgments can have on the results of operations. In addition, changes in economic conditions can have a significant impact on real estate values of underlying collateral affecting the allowance for loan losses and therefore the provision for loan losses and results of operations as well as the valuation of foreclosed real estate. Bancorp has developed policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. Bancorp's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations, and the discovery of information with respect to borrowers that is not known to management at the time of the issuance of the consolidated financial statements.

### **Financial Condition**

Total assets decreased by \$61,915,000, or 6.4%, at December 31, 2011 to \$900,628,000, compared to \$962,543,000 at December 31, 2010. The following discusses the material changes between the December 31, 2011 and 2010 statements of financial condition.

#### **Cash**

Cash and cash equivalents increased by \$16,435,000, or 23.2%, at December 31, 2011 to \$87,390,000, compared to \$70,955,000 at December 31, 2010. This increase was primarily due to management's decision to increase liquidity to offset any potential decreases in customer deposits due to the economic slowdown. This was achieved by retaining more customer deposits than necessary given the lower loan demand and loan payoffs.

#### **Investments**

Investment securities held to maturity increased by \$13,046,000, or 47.8%, at December 31, 2011 to \$40,357,000, compared to \$27,311,000 at December 31, 2010. This increase was primarily due to management's

decision to purchase US Treasury and agency securities in place of lower yielding overnight investments with funds generated from a decrease in the loan portfolio.

### **Loans**

**Loans Held For Sale.** Loans held for sale increased by \$702,000, or 20.5% at December 31, 2011 to \$4,128,000, compared to \$3,426,000 at December 31, 2010. This increase was primarily due to the timing of loans pending sale as of December 31, 2011 compared to as of December 31, 2010.

**Loans Receivable.** Total loans receivable, net decreased by \$85,634,000, or 11.0% at December 31, 2011, to \$693,303,000, compared to \$778,937,000 at December 31, 2010. The decrease in the loan portfolio was a result of decreased loan demand from the economic slowdown. In addition, the allowance for loan losses decreased by \$3,933,000, or 13.2%, at December 31, 2011 to \$25,938,000, compared to \$29,871,000 at December 31, 2010. The decrease in the allowance was primarily due to a decrease in loans receivable and an improvement in loan delinquencies and non-accrual loans.

### **Foreclosed Real Estate**

Foreclosed real estate decreased by \$1,023,000, or 4.9%, at December 31, 2011 to \$19,932,000, compared to \$20,955,000 at December 31, 2010. This decrease was primarily due to foreclosed properties being sold and additional write downs taken partially offset by new loan foreclosures.

### **Premises and Equipment**

Premises and equipment decreased by \$1,109,000, or 3.9%, at December 31, 2011 to \$27,218,000, compared to \$28,327,000 at December 31, 2010. This decrease was primarily due to the annual depreciation of the premises and equipment with minimal new fixed assets added throughout 2011.

### **Other Assets**

Other assets decreased by \$3,583,000, or 14.4%, at December 31, 2011 to \$21,357,000, compared to \$24,940,000 at December 31, 2010. This decrease was primarily due to decreases in net deferred income taxes of \$888,000, income taxes receivable of \$762,000, and prepaid expenses of \$1,393,000 in 2011.

### **Liabilities**

**Deposits.** Total deposits decreased by \$62,019,000, or 8.7%, at December 31, 2011 to \$652,757,000, compared to \$714,776,000 at December 31, 2010. This decrease was primarily attributable to decreases in certificates of deposits of \$37,030,000 and passbooks of \$32,487,000 partially offset by increases of \$7,498,000 in other deposit categories due to management's decision to actively promote its demand deposits.

**FHLB-Atlanta Advances.** FHLB-Atlanta advances at December 31, 2011 were \$115,000,000, which was unchanged from December 31, 2010. There were no contractual advance payoffs scheduled during 2011 and no additional advances were needed as cash increased during the year from the proceeds from loan payoffs.

**Junior Subordinated Debt Securities Due 2035.** As of December 31, 2011, Bancorp had outstanding approximately \$20,619,000 principal amount of Junior Subordinated Debt Securities Due 2035 (the "2035 Debentures"). The 2035 Debentures were issued pursuant to an Indenture dated as of December 17, 2004 (the "2035 Indenture") between Bancorp and Wells Fargo Bank, National Association as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of 3-month LIBOR (0.40% December 31, 2011) plus 200 basis points, and mature on January 7, 2035. Payments of principal, interest, premium and other amounts under the 2035 Debentures are subordinated and junior in right of payment to the prior payment in full of all senior indebtedness of Bancorp, as defined in the 2035 Indenture. The 2035 Debentures became redeemable, in whole or in part, by Bancorp on January 7, 2010.

The 2035 Debentures were issued and sold to Severn Capital Trust I (the "Trust"), of which 100% of the common equity is owned by Bancorp. The Trust was formed for the purpose of issuing corporation-obligated mandatorily redeemable Capital Securities ("Capital Securities") to third-party investors and using the proceeds from the sale of such Capital Securities to purchase the 2035 Debentures. The 2035 Debentures held by the Trust are the sole assets of the Trust. Distributions on the Capital Securities issued by the Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Trust on the 2035 Debentures. The Capital Securities are subject to mandatory redemption, in whole or in part, upon repayment of the 2035 Debentures. Bancorp has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee.

**Subordinated Notes and Series A Preferred Stock.** On November 15, 2008, Bancorp completed a private placement offering consisting of a total of 70 units, at an offering price of \$100,000 per unit, for gross proceeds of \$7,000,000. Each unit consists of 6,250 shares of Bancorp's Series A 8.0% Non-Cumulative Convertible Preferred Stock and Bancorp's Subordinated Note in the original principal amount of \$50,000. The Subordinated Notes earn interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31, 2018.

**Troubled Asset Relief Program.** On November 21, 2008, Bancorp closed on an agreement with the United States Department of the Treasury ("Treasury"), pursuant to which Bancorp issued and sold (i) 23,393 shares of its Series B Fixed Rate Cumulative Perpetual Preferred Stock, par value \$0.01 per share and liquidation preference \$1,000 per share, (the "Series B Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 556,976 shares of Bancorp's common stock, par value \$0.01 per share, for an aggregate purchase price of \$23,393,000.

The Series B Preferred Stock qualifies as Tier 1 capital and will pay cumulative compounding dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series B Preferred Stock may be redeemed by Bancorp after three years. Prior to the end of three years, the Series B Preferred Stock may not be redeemed by Bancorp except with proceeds from one or more Qualified Equity Offerings, as defined in the Purchase Agreement.

The Series B Preferred Stock has no maturity date and ranks *pari passu* with Bancorp's existing Series A Preferred Stock, in terms of dividend payments and distributions upon liquidation, dissolution and winding up of Bancorp.

The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, Bancorp's authorized number of directors will be automatically increased by two and the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, will have the right to elect those directors at Bancorp's next annual meeting of stockholders or at a special meeting of stockholders called for that purpose. These preferred share directors will be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid.

The Warrant has a 10-year term and is immediately exercisable at an exercise price of \$6.30 per share of Common Stock. The exercise price and number of shares subject to the Warrant are both subject to anti-dilution adjustments. Pursuant to the Purchase Agreement, Treasury has agreed not to exercise voting power with respect to any shares of Common Stock issued upon exercise of the Warrant.

**Off-Balance Sheet Arrangements.** Bancorp has certain outstanding commitments and obligations that could impact Bancorp's financial condition, liquidity, revenues or expenses. These commitments and obligations include standby letters of credit, home equity lines of credit, loan commitments, lines of credit, and loans sold and serviced with limited repurchase provisions.

Standby letters of credit, which are obligations of Bancorp to guarantee performance of borrowers to governmental entities, decreased \$2,640,000, or 14.7%, as of December 31, 2011 to \$15,319,000, compared to \$17,959,000 as of December 31, 2010. In 2011, Bancorp experienced a decrease in demand from its borrowers for letter of credit requirements.

Unadvanced construction loans decreased \$8,648,000, or 32.4%, as of December 31, 2011 to \$18,014,000, compared to \$26,662,000 as of December 31, 2010. This decrease was primarily the result of the funding of existing construction loan obligations outpacing new construction loan originations.

Home equity lines of credit increased \$283,000, or 2.0%, as of December 31, 2011 to \$14,623,000, compared to \$14,340,000 as of December 31, 2010. This increase was primarily due to greater customer demand for home equity loans in 2011. Home equity lines of credit allow the borrowers to draw funds up to a specified loan amount, from time to time. Bancorp's management believes it has sufficient liquidity resources to have the funding available as these borrowers draw on these loans.

Mortgage loan commitments decreased \$4,768,000, or 81.8%, as of December 31, 2011 to \$1,059,000, compared to \$5,827,000 as of December 31, 2010. This decrease was primarily due to the timing of loan commitments booked at year end. Loan commitments are obligations of Bancorp to provide loans, and such commitments are made in the usual course of business.

Lines of credit, which are obligations of Bancorp to fund loans made to certain borrowers, increased \$5,692,000, or 22.0%, to \$31,525,000 as of December 31, 2011, compared to \$25,833,000 as of December 31, 2010. The increase was a result of more demand for this type of loan product during 2011. Bancorp's management believes it has sufficient liquidity resources to have the funding available as these borrowers draw on these loans.

Loans sold and serviced with limited repurchase provisions decreased \$20,385,000, or 53.7% as of December 31, 2011 to \$17,558,000, compared to \$37,943,000 as of December 31, 2010. This decrease was the result of a lower volume of loans sold in the secondary market in 2011.

Bancorp uses the same credit policies in making commitments and conditional obligations as it does for its on-balance sheet instruments.

#### **Comparison of Results of Operations for the Years Ended December 31, 2011 and 2010.**

**General.** Bancorp's net income for the year ended December 31, 2011 was \$1,219,000, or a loss of \$(0.05) per share diluted after giving effect to dividends paid on preferred stock and amortization of discount on preferred stock. This compared to net income of \$1,157,000, or a loss of \$(0.06) per share diluted in 2010. This increase of \$62,000 was primarily the result of the economic environment Bancorp experienced in 2011 compared to 2010, including a decrease in net interest income, a decrease in the provision for loan losses, a decrease in income tax provision and a decrease in non-accrual loans.

**Net Interest Income.** Net interest income (interest earned net of interest charges) decreased \$1,290,000, or 4.3%, to \$28,914,000 for the year ended December 31, 2011, compared to \$30,204,000 for the year ended December 31, 2010. This decrease was primarily due to a decrease in Bancorp's volume. Bancorp's interest rate spread decreased by 0.02% to 3.34% for the year ended December 31, 2011, compared to 3.36% for the year ended December 31, 2010. This decrease was the result of interest rates earned on Bancorp's loan portfolio decreasing faster than the decrease in interest rates paid on Bancorp's interest bearing liabilities. In addition, Bancorp's non-accrual loans decreased from \$46,164,000 at December 31, 2010 to \$31,432,000 at December 31, 2011. This resulted in \$2,083,000 of interest income not recorded on non-accrual loans in 2011, compared to \$2,306,000 of unrecorded interest in 2010. Bancorp discontinues the accrual of interest on all non-accrual loans, at which time all previously accrued but uncollected interest is deducted from income. Bancorp is uncertain whether it will be able to further reduce the interest rate paid on its interest bearing liabilities by attracting lower cost deposits, due to the general expectation of continued increased competition for deposit accounts.

**Provision for Loan Losses.** Bancorp's loan portfolio is subject to varying degrees of credit risk and an allowance for loan losses is maintained to absorb losses inherent in its loan portfolio. Credit risk includes, but is not limited to, the potential for borrower default and the failure of collateral to be worth what the Bank determined it was worth at the time of the granting of the loan. The Bank monitors its loan portfolio loan delinquencies at least as often as monthly. All loans that are delinquent and all loans within the various categories of the Bank's portfolio as a group are evaluated. The Bank's Board, with the advice and recommendation of the Bank's loss mitigation committee, estimates an allowance to be set aside for loan losses. Included in determining the calculation are such



factors as historical losses for each loan portfolio, current market value of the loan's underlying collateral, inherent risk contained within the portfolio after considering the state of the general economy, economic trends, consideration of particular risks inherent in different kinds of lending and consideration of known information that may affect loan collectibility. A decrease in the loan loss provision from the beginning of the year to the end of a year is the result after an analysis of the aforementioned factors and applying that rationale to the total portfolio.

The total allowance for loan losses decreased \$3,933,000, or 13.2%, to \$25,938,000 as of December 31, 2011, compared to \$29,871,000 as of December 31, 2010. The decrease in the allowance was due to a decrease in loans receivable, an improvement in loan delinquencies and non-accrual loans offset in part by an increase in impaired loans primarily due to a slowdown in foreclosed loans transferred to foreclosed real estate. During the year ended December 31, 2011, the provision for loan losses was \$4,612,000 compared to \$5,744,000 for the year ended December 31, 2010. This decrease of \$1,132,000, or 19.7%, was a result of management's determination that less of a provision for loan losses was needed for the level of inherent risk in its portfolio for the year ended December 31, 2011 as compared to the year ended December 31, 2010.

Bancorp's total loan portfolio has decreased from 2010. In addition, Bancorp has experienced a modest decrease in loan delinquencies, which contributed to the decision to reduce the provision for loan losses from 2010. Management believes that Bancorp will continue to experience improvement in the challenges faced by many financial institutions resulting from the slowdown in the economy and real estate markets.

**Other Income and Non Interest Expenses.** Total other income decreased \$235,000, or 8.6%, to \$2,510,000 for 2011 compared to \$2,745,000 for 2010.

Revenues from mortgage banking activities decreased \$267,000, or 31.7%, to \$576,000 for the year ended December 31, 2011, compared to \$843,000 for the year ended December 31, 2010. This decrease was primarily a result of the market conditions which affected our ability to originate loans to be sold in the secondary market.

Real estate commissions increased \$63,000, or 10.6%, to \$657,000 for the year ended December 31, 2011, compared to \$594,000 for the year ended December 31, 2010. This increase was primarily the result of an increase in commercial sales and leasing in 2011 compared to 2010.

Real estate management fees increased \$52,000, or 9.1%, to \$625,000 for the year ended December 31, 2011, compared to \$573,000 for the year ended December 31, 2010. This increase was primarily due to increased fees charged in 2011.

Other non-interest income decreased \$83,000, or 11.3%, to \$652,000 for the year ended December 31, 2011, compared to \$735,000 for the year ended December 31, 2010. This decrease was primarily due to lower credit report and ATM surcharges fees offset by higher letter of credit fees, savings charges, and NSF fees.

Total non-interest expense decreased \$397,000, or 1.6%, to \$24,611,000 for 2011 compared to \$25,008,000 for 2010.

Compensation and related expenses increased \$572,000, or 6.0%, to \$10,155,000 for the year ended December 31, 2011, compared to \$9,583,000 for the year ended December 31, 2010. This increase was primarily the result of the hiring of higher level management and other additional personnel in 2011 and the resulting compensation for these employees in 2011 compared to 2010. As of December 31, 2011, Bancorp had 127 full-time equivalent employees compared to 116 at December 31, 2010.

Occupancy expense decreased \$219,000, or 14.9%, to \$1,247,000 for the year ended December 31, 2011, compared to \$1,466,000 for the year ended December 31, 2010. This decrease was primarily due to lower maintenance costs incurred at Bancorp's headquarters.

Foreclosed real estate expenses, net decreased \$109,000, or 2.0%, to \$5,409,000 for the year ended December 31, 2011, compared to \$5,518,000 for the year ended December 31, 2010. This decrease was primarily due to a decrease in loans foreclosed on, lower write downs taken on foreclosed property and lower expenses associated with the maintenance of foreclosed property in 2011 compared to 2010.

Legal fees decreased \$353,000, or 28.1%, to \$905,000 for the year ended December 31, 2011, compared to \$1,258,000 for the year ended December 31, 2010. This decrease was primarily due to a decrease in fees associated with loan foreclosures and loan collections in 2011 compared to 2010.

The FDIC assessment decreased \$51,000, or 2.2%, to \$2,231,000 for the year ended December 31, 2011, compared to \$2,282,000 for the year ended December 31, 2010. This decrease was primarily the result of decreased premiums charged by the FDIC in 2011 due to a decrease in insured deposits.

Other non-interest expense decreased \$237,000, or 4.8%, to \$4,664,000 for the year ended December 31, 2011, compared to \$4,901,000 for the year ended December 31, 2010. This decrease was primarily the result of a decrease in credit reports, office expense, postage and telephone and partially offset by advertising, accounting, contributions, dues and subscriptions, property management fees, on-line charges, bank service charges and savings account losses.

**Income Taxes.** Income taxes decreased \$58,000, to an income tax expense of \$982,000 compared to income tax expense of \$1,040,000 for the year ended December 31, 2010. The effective tax rate for the years ended December 31, 2011 and 2010 was 44.6% and 47.3%, respectively.

### **Comparison of Results of Operations for the Years Ended December 31, 2010 and 2009.**

**General.** Bancorp's net income for the year ended December 31, 2010 was \$1,157,000, or a loss of \$(0.06) per share diluted after giving effect to dividends paid on preferred stock and amortization of discount on preferred stock. This is compared to net loss of \$(15,228,000), or a loss of \$(1.68) per share diluted in 2009. This increase of \$16,385,000 was primarily the result of the improved economic environment Bancorp experienced in 2010 compared to 2009, including an increase in net interest income, a decrease in the provision for loan losses and a decrease in non-accrual loans.

**Net Interest Income.** Net interest income (interest earned net of interest charges) increased \$3,597,000, or 13.5%, to \$30,204,000 for the year ended December 31, 2010, compared to \$26,607,000 for the year ended December 31, 2009. This increase was primarily due to an increase in Bancorp's interest rate spread. Bancorp's interest rate spread increased by 0.72% to 3.36% for the year ended December 31, 2010, compared to 2.64% for the year ended December 31, 2009. This increase was the result of interest rates earned on Bancorp's loan portfolio decreasing slower than the decrease in interest rates paid on Bancorp's interest bearing liabilities. In addition, Bancorp's non-accrual loans decreased from \$60,808,000 at December 31, 2009 to \$46,164,000 at December 31, 2010. This resulted in \$2,307,000 of interest income not recorded on non-accrual loans in 2010, compared to \$3,317,000 of unrecorded interest in 2009.

**Provision for Loan Losses.** The total allowance for loan losses decreased \$4,822,000, or 13.9%, to \$29,871,000 as of December 31, 2010, compared to \$34,693,000 as of December 31, 2009. Management's decision to decrease the allowance was due to a decrease in loans receivable, an improvement in loan delinquencies and a reduction in impaired loans primarily due to foreclosed loans transferred to foreclosed real estate. During the year ended December 31, 2010, the provision for loan losses was \$5,744,000 compared to \$31,402,000 for the year ended December 31, 2009. This decrease of \$25,658,000, or 81.7%, was a result of management's determination that less of a provision for loan losses was needed for the level of inherent risk in its portfolio for the year ended December 31, 2010 as compared to the year ended December 31, 2009.

**Other Income and Non Interest Expenses.** Total other income increased \$244,000, or 9.8%, to \$2,745,000 for 2010 compared to \$2,501,000 for 2009.

Revenues from mortgage banking activities increased \$527,000, or 166.8%, to \$843,000 for the year ended December 31, 2010, compared to \$316,000 for the year ended December 31, 2009. This increase was primarily a result of the management's increased focus on originating loans to be sold in the secondary market.

Real estate commissions decreased \$96,000, or 13.9%, to \$594,000 for the year ended December 31, 2010, compared to \$690,000 for the year ended December 31, 2009. This decrease was primarily the result of a decrease in commercial sales and leasing in 2010 compared to 2009.

Real estate management fees decreased \$104,000, or 15.4%, to \$573,000 for the year ended December 31, 2010, compared to \$677,000 for the year ended December 31, 2009. This decrease was primarily due to decreased fees charged in 2010.

Other non-interest income decreased \$83,000, or 10.1%, to \$735,000 for the year ended December 31, 2010, compared to \$818,000 for the year ended December 31, 2009. This decrease was primarily due to lower credit report fees, letter of credit fees, savings charges, and NSF fees, partially offset by higher safe deposit box fees and ATM surcharges.

Total non-interest expense increased \$2,416,000, or 9.4%, to \$25,008,000 for 2010 compared to \$22,862,000 for 2009.

Compensation and related expenses increased \$206,000, or 2.2%, to \$9,583,000 for the year ended December 31, 2010, compared to \$9,377,000 for the year ended December 31, 2009. This increase was primarily the result of the hiring of higher level management personnel in 2010 and the resulting higher compensation for these employees in 2010 compared to 2009. As of December 31, 2010, Bancorp had 116 full-time equivalent employees compared to 118 at December 31, 2009.

Occupancy expense increased \$101,000, or 7.4%, to \$1,466,000 for the year ended December 31, 2010, compared to \$1,365,000 for the year ended December 31, 2009. This increase was primarily due to higher maintenance costs incurred at Bancorp's headquarters.

Foreclosed real estate expenses, net increased \$635,000, or 13.0%, to \$5,518,000 for the year ended December 31, 2010, compared to \$4,883,000 for the year ended December 31, 2009. This increase was primarily due to an increase in loans foreclosed on, higher write downs taken on foreclosed property and expenses associated with the maintenance of foreclosed property in 2010 compared to 2009.

Legal fees increased \$255,000, or 25.4%, to \$1,258,000 for the year ended December 31, 2010, compared to \$1,003,000 for the year ended December 31, 2009. This increase was primarily due to an increase in fees associated with loan foreclosures and loan collections in 2010 compared to 2009.

The FDIC assessment increased \$126,000, or 5.8%, to \$2,282,000 for the year ended December 31, 2010, compared to \$2,156,000 for the year ended December 31, 2009. This increase was primarily the result of increased premiums charged by the FDIC in 2010 for the change in the maximum amount of FDIC deposit insurance from \$100,000 per account to \$250,000 per account, and to replenish the FDIC for an increased number of bank failures in 2009 and 2010.

Other non-interest expense increased \$823,000, or 20.2%, to \$4,901,000 for the year ended December 31, 2010, compared to \$4,078,000 for the year ended December 31, 2009. This increase was primarily the result of an increase in advertising, accounting, credit reports, contributions, dues and subscriptions, office expense, property management fees, postage, on-line charges and telephone partially offset by bank service charges and savings account losses.

**Income Taxes.** Income taxes increased \$10,968,000, to an income tax expense of \$1,040,000 compared to income tax benefit of \$9,928,000 for the year ended December 31, 2009. The effective tax rate for the years ended December 31, 2010 and 2009 was 47.3% and (39.5)%, respectively.

### **Liquidity and Capital Resources**

In 2011, Bancorp's sources of liquidity were loan repayments, maturing investments, deposits, borrowed funds, and the sale of loans. Bancorp considers core deposits stable funding sources and includes all deposits, except time deposits of \$100,000 or more. At December 31, 2011, core deposits equaled 76% of total deposits. The Bank's experience has been that a substantial portion of certificates of deposit renew at time of maturity and remain on deposit with the Bank. Additionally, loan payments, maturities, deposit growth and earnings contributed to Bancorp's flow of funds.

In addition to its ability to generate deposits, Bancorp has external sources of funds, which may be drawn upon when desired. The primary source of external liquidity is an available line of credit with the FHLB-Atlanta. The Bank's credit availability under the FHLB of Atlanta's credit availability program was \$184,400,000 at December 31, 2011, of which \$115,000,000 was outstanding. The Bank is able to borrow up to 20% of total assets.

The maturities of these long-term advances at December 31, 2011 were as follows (dollars in thousands):

Rate	Amount	Maturity
-%	\$ -	2012
-%	-	2013
2.940% to 4.210%	25,000	2014
3.710% to 4.340%	40,000	2015
-%	-	2016
2.580% to 4.050%	50,000	Thereafter
	<u>\$115,000</u>	

As of December 31, 2011, Bancorp had outstanding an aggregate of \$24,119,000 principal amount of subordinated debt, consisting of the 2035 Debentures and the Subordinated Notes. The 2035 Debentures total \$20,619,000, pay interest quarterly at a floating rate of interest of 3-month LIBOR (0.40% December 31, 2011) plus 200 basis points, and mature on January 7, 2035. The Subordinated Notes total \$3,500,000 and pay interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31, 2018.

As of December 31, 2011, Bancorp had \$1,059,000 outstanding in loan commitments, and unadvanced construction commitments of \$18,014,000 which Bancorp expects to fund from the sources of liquidity described above. These amounts do not include undisbursed lines of credit, home equity lines of credit and standby letters of credit, in the aggregate amount of \$61,467,000 at December 31, 2011, which Bancorp anticipates it will be able to fund, if required, from these liquidity sources in the regular course of business.

In addition to the foregoing, the payment of dividends is a use of cash, but is not expected to have a material effect on liquidity. As of December 31, 2011, Bancorp had no material commitments for capital expenditures.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary, actions by the regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Management believes, as of December 31, 2011, that the Bank meets all capital adequacy requirements to which it is subject.

We anticipate that our primary sources of liquidity in fiscal 2012 will be from loan repayments, maturing investments, deposits, borrowed funds, and the sale of loans. We believe that these sources of liquidity will be enough for Bancorp to meet its liquidity needs over the next twelve months. Cash generated from these liquidity sources may be affected by a number of factors. See "Risk Factors" for a discussion of the factors that can negatively impact the amount of cash we could receive.

### **Contractual Obligations**

The following table contains, for the periods indicated, information regarding the financial obligations owing by Bancorp under contractual obligations.

	Payments due by period (dollars in thousands)				
	<u>Total</u>	<u>Less than 1 year</u>	<u>1 to 3 years</u>	<u>3 to 5 years</u>	<u>More than 5 years</u>
Long-term borrowings	\$115,000	\$-	\$25,000	\$40,000	\$50,000
Subordinated debentures	24,119	-	-	-	24,119
Operating lease obligations	365	96	194	75	-
Certificates of Deposit	383,103	254,873	104,169	24,061	-
Total	<u>\$522,587</u>	<u>\$254,969</u>	<u>\$129,363</u>	<u>\$64,136</u>	<u>\$74,119</u>

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

**Qualitative Information About Market Risk.** The principal objective of Bancorp's interest rate risk management is to evaluate the interest rate risk included in balance sheet accounts, determine the level of risks appropriate given Bancorp's business strategy, operating environment, capital and liquidity requirements and performance objectives, and manage the risk consistent with Bancorp's interest rate risk management policy. Through this management, Bancorp seeks to reduce the vulnerability of its operations to changes in interest rates. The Board of Directors of Bancorp is responsible for reviewing assets/liability policies and interest rate risk position. The Board of Directors reviews the interest rate risk position on a quarterly basis and, in connection with this review, evaluates Bancorp's business activities and strategies, the effect of those strategies on Bancorp's net interest margin and the effect that changes in interest rates will have on Bancorp's loan portfolio. While continuous movement of interest rates is certain, the extent and timing of these movements is not always predictable. Any movement in interest rates has an effect on Bancorp's profitability. Bancorp faces the risk that rising interest rates could cause the cost of interest bearing liabilities, such as deposits and borrowings, to rise faster than the yield on interest earning assets, such as loans and investments. Bancorp's interest rate spread and interest rate margin may be negatively impacted in a declining interest rate environment even though Bancorp generally borrows at short-term interest rates and lends at longer-term interest rates. This is because loans and other interest earning assets may be prepaid and replaced with lower yielding assets before the supporting interest bearing liabilities reprice downward. Bancorp's interest rate margin may also be negatively impacted in a flat or inverse-yield curve environment. Mortgage origination activity tends to increase when interest rates trend lower and decrease when interest rates rise.

Bancorp's primary strategy to control interest rate risk is to sell substantially all long-term fixed-rate loans in the secondary market. To further control interest rate risk related to its loan portfolio, Bancorp originates construction loans that typically have terms of one year or less. The turnover in construction loan portfolio assists Bancorp in maintaining a reasonable level of interest rate risk.

**Quantitative Information About Market Risk.** The primary market risk facing Bancorp is interest rate risk. From an enterprise prospective, Bancorp manages this risk by striving to balance its loan origination activities with the interest rate market. Bancorp attempts to maintain a substantial portion of its loan portfolio in short-term loans such as construction loans. This has proven to be an effective hedge against rapid increases in interest rates as the construction loan portfolio reprices rapidly.

The matching of maturity or repricing of interest earning assets and interest bearing liabilities may be analyzed by examining the extent to which these assets and liabilities are interest rate sensitive and by monitoring the Bank's interest rate sensitivity gap. An interest earning asset or interest bearing liability is interest rate sensitive within a specific time period if it will mature or reprice within that time period. The difference between rate sensitive assets and rate sensitive liabilities represents the Bank's interest sensitivity gap.

Exposure to interest rate risk is actively monitored by Bancorp's management. Its objective is to maintain a consistent level of profitability within acceptable risk tolerances across a broad range of potential interest rate environments. Bancorp uses the OTS Net Portfolio Value ("NPV") model to monitor its exposure to interest rate risk, which calculates changes in NPV. The following table represents Bancorp's NPV at December 31, 2011. The NPV was calculated by the OCC, based upon information provided to the OCC.

INTEREST RATE SENSITIVITY OF NET PORTFOLIO VALUE (NPV)					
Change In Rates	\$ Amount	Net Portfolio Value		NPV as % of PV of Assets	
		\$ Change	% Change	NPV Ratio	Change
		(dollars are in thousands)			
+300bp	152,001	7,927	6%	16.44%	112bp
+200bp	150,091	6,017	4%	16.13%	81bp
+100bp	147,889	3,815	3%	15.80%	48bp
+50bp	145,767	1,694	1%	15.54%	22bp
0bp	144,074			15.32%	
-50bp	141,439	(2,635)	(2%)	15.03%	(28bp)
-100bp	139,893	(4,181)	(3%)	14.88%	(44bp)

The above table suggests that if interest rates rise 100 bps, Bancorp's interest sensitive assets would increase in value by \$3,815,000.

#### **Item 8. Financial Statements and Supplementary Data**

Financial statements and supplementary data are included herein at pages F-1 through F-48, and incorporated herein by reference.

#### **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

#### **Item 9A. Controls and Procedures**

Under the supervision and with the participation of Bancorp's management, including its Chief Executive Officer and Chief Financial Officer, Bancorp has evaluated the effectiveness of its disclosure controls and procedures (as defined in Securities Exchange Act Rule 13a-15(e)) as of December 31, 2011. Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the period covered by this report, Bancorp's disclosure controls and procedures were effective in reaching a reasonable level of assurance that (i) information required to be disclosed by Bancorp in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (ii) information required to be disclosed by Bancorp in its reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to its management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Bancorp's management, with the participation of its Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of Bancorp's internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f), to determine whether any changes occurred during the quarter ended December 31, 2011, that have materially affected, or are reasonably likely to materially affect, Bancorp's internal control over financial reporting. Based on that evaluation, there were no such changes during the quarter ended December 31, 2011.

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within Bancorp have been detected. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Severn Bancorp, Inc. ("Bancorp") is responsible for the preparation, integrity, and fair presentation of the consolidated financial statements included in this annual report. The consolidated financial statements and notes included in this annual report have been prepared in conformity with accounting principles generally accepted in the United States of America, and as such, include some amounts that are based on management's best estimates and judgments.

Bancorp's management is responsible for establishing and maintaining effective internal control over financial reporting. The system of internal control over financial reporting, as it relates to the consolidated financial statements, is evaluated for effectiveness by management and tested for reliability through a program of internal audits and management testing and review. Actions are taken to correct potential deficiencies as they are identified. Any system of internal control, no matter how well designed, has inherent limitations, including the possibility that a control can be circumvented or overridden and misstatements due to error or fraud may occur and not be detected. Also, because of changes in conditions, internal control effectiveness may vary over time. Accordingly, even an effective system of internal control will provide only reasonable assurance with respect to financial statement preparation.

Management assessed the effectiveness of Bancorp's internal control over financial reporting as of December 31, 2011. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control – Integrated Framework*. Based on its assessment, management concluded that as of December 31, 2011, Bancorp's internal control over financial reporting is effective and meets the criteria of the *Internal Control – Integrated Framework*.

This annual report does not include an attestation report of Bancorp's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by Bancorp's registered public accounting firm pursuant to a provision of the Dodd-Frank Act which eliminates such requirement for "smaller reporting companies", as defined in SEC regulations.

## **Item 9B. Other Information**

The executive officers of Bancorp are employees at-will of the Bank. The Board of Directors of the Bank has a Compensation Committee, which determines the compensation of the executive officers of Bancorp. Annually, the Compensation Committee of the Bank's Board of Directors evaluates profiles of comparable financial institutions to assure that the compensation to its executive officers is comparable to its peer group. Other factors used by the Compensation Committee in determining compensation for its executive officers include an assessment of the overall financial condition of the Bank, including an analysis of the Bank's asset quality, interest rate risk exposure, capital position, net income and consistency of earnings. The Bank's return on average assets and return on equity is considered and compared to its peer group. The complexity of the activities of the executive officers are considered, and intangible items are considered such as the reputation and general standing of the Bank within the community and the likelihood of continuing successful and profitable results.

Based on the considerations set forth above, at its meeting on November 18, 2011, the Compensation Committee awarded Messrs. Hyatt and Bevivino a discretionary bonus totaling \$15,000 and \$10,000, respectively. The Compensation Committee concluded that a modest bonus should be awarded for 2011 in line with what was awarded in 2010 because Bancorp's performance in 2011 was similar to 2010. In addition, the Compensation Committee determined that Mr. Hyatt would receive an approximately 5% increase in base salary for 2012 as he had in 2011. Effective December 1, 2011, Mr. Bevivino's role with Bancorp changed from Chief Financial Officer to Chief Operating Officer. Therefore, Mr. Hyatt's and Mr. Bevivino's 2012 base salary will be \$372,000 and \$225,000, respectively. Effective January 1, 2012, Mr. Jones' base salary will be \$120,000.

## **PART III**

### **Item 10. Directors, Executive Officers and Corporate Governance**

Reference is made to the section captioned "Discussion of Proposals Recommended by the Board - Proposal 1: Election of Directors" in Bancorp's Proxy Statement relating to the 2012 Annual Stockholders Meeting ("Proxy Statement"), and the information contained in item 4.1 of this Form 10-K, for the information required by this Item, which is hereby incorporated by reference.

Reference is made to the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference.

Bancorp has adopted a code of ethics that applies to its employees, including its chief executive officer, chief financial officer, and persons performing similar functions and directors. A copy of the code of ethics is filed as an exhibit to Bancorp's Form 10-K for the year ended December 31, 2003, which was filed with the Securities and Exchange Commission on March 25, 2004.

### **Item 11. Executive Compensation**

Reference is made to the section captioned "Executive and Director Compensation" in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference.



**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Reference is made to the section captioned “Stock Ownership,” in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference. The following table provides certain information as of December 31, 2011 with respect to Bancorp's equity based compensation plans.

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u>	<u>Weighted-average exercise price of outstanding options, warrants and rights</u>	<u>Number of securities remaining available for future issuance under equity compensation plans</u>
Equity compensation plan approved by security holders	100,000	\$4.21	522,501
Equity compensation plans not approved by security holders	-	-	-
<b>Total</b>	<b>100,000</b>	<b>\$4.21</b>	<b>522,501</b>

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

Reference is made to the sections captioned “Executive and Director Compensation - Compensation Committee Interlocks and Insider Participation,” and “Executive and Director Compensation - Certain Transactions With Related Persons” in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference.

Reference is made to the section captioned “Director Independence” in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference.

**Item 14. Principal Accounting Fees and Services**

Reference is made to the section captioned “Discussion of Proposals Recommended by the Board – Proposal 2: Ratification of Appointment of Independent Auditor” in Bancorp's Proxy Statement for the information required by this Item, which is hereby incorporated by reference.

## **PART IV**

### **Item 15. Exhibits, Financial Statement Schedules**

(a) The following consolidated financial statements of Bancorp and its wholly owned subsidiaries are filed as part of this report:

1. **Financial Statements**

- Report of ParenteBeard LLC, independent registered public accounting firm.
- Consolidated statements of financial condition at December 31, 2011 and December 31, 2010
- Consolidated statements of operations for the years ended December 31, 2011, 2010, and 2009
- Consolidated statements of cash flows for the years ended December 31, 2011, 2010, and 2009
- Consolidated statements of stockholders' equity for the years ended December 31, 2011, 2010 and 2009
- Notes to consolidated financial statements

2. **Financial Statement Schedules**

All financial statement schedules have been omitted, as required information is either inapplicable or included in the consolidated financial statements or related notes.

3. **Exhibits**

The following exhibits are filed as part of this report:

<b><u>Exhibit No.</u></b>	<b><u>Description of Exhibit</u></b>
3.1	Articles of Incorporation of Severn Bancorp, Inc., as amended <sup>(1)</sup>
3.2	Bylaws of Severn Bancorp, Inc., as amended <sup>(2)</sup>
4.1	Warrant for Purchase of Shares of Common Stock <sup>(3)</sup>
10.1+	Stock Option Plan <sup>(4)</sup>
10.2+	Employee Stock Ownership Plan <sup>(5)</sup>
10.3+	Form of Common Stock Option Agreement <sup>(6)</sup>
10.4+	2008 Equity Incentive Plan <sup>(7)</sup>
10.5+	Form of Subscription Agreement <sup>(8)</sup>
10.6	Form of Subordinated Note <sup>(8)</sup>
10.7	Purchase Agreement, dated November 21, 2008, between Bancorp and the United States Department of the Treasury <sup>(3)</sup>
10.8	Supervisory Agreement dated November 23, 2009 between Severn Savings Bank, FSB and the OTS <sup>(9)</sup>
10.9	Supervisory Agreement dated November 23, 2009 between Severn Bancorp, Inc. and the OTS <sup>(9)</sup>
10.10+	Form of Director Option Award <sup>(10)</sup>
10.11+	Form of Employee Option Award <sup>(10)</sup>
14	Code of Ethics <sup>(11)</sup>
21.1	Subsidiaries of Severn Bancorp, Inc.
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of CEO pursuant to Section 302 of Sarbanes-Oxley Act of 2002
31.2	Certification of CFO pursuant to Section 302 of Sarbanes-Oxley Act of 2002
32	Certification of CEO and CFO pursuant to Section 906 of Sarbanes-Oxley Act of 2002
99.1	31 C.F.R. § 30.15 Certification of Principal Executive Officer
99.2	31 C.F.R. § 30.15 Certification of Principal Financial Officer

101 The following financial statements from Severn Bancorp, Inc. Annual Report on Form 10-K as of December 31, 2011, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Statements of Financial Condition; (ii) the Consolidated Statements of Operations; (iii) the Consolidated Statements of Stockholders' Equity; (iv) the Consolidated Statements of Cash Flows; and (v) the Notes to Consolidated Financial Statements. Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

+ Denotes management contract, compensatory plan or arrangement.

<sup>(1)</sup> Incorporated by reference from Bancorp's Annual Report on Form 10-K for fiscal year ended December 31, 2008 and filed with the Securities and Exchange Commission on March 11, 2009.

<sup>(2)</sup> Incorporated by reference from Bancorp's Annual Report on Form 10-K for fiscal year ended December 31, 2007 and filed with Securities and Exchange Commission on March 12, 2008.

<sup>(3)</sup> Incorporated by reference from Bancorp's Current Report on Form 8-K filed with the Securities and Exchange Commission on November 24, 2008.

<sup>(4)</sup> Incorporated by reference from Bancorp's Annual Report on Form 10-K filed for fiscal year ended December 31, 2004 and with the Securities and Exchange Commission on March 21, 2005.

<sup>(5)</sup> Incorporated by reference from Bancorp's Registration Statement on Form 10 filed with the Securities and Exchange Commission on June 7, 2002.

<sup>(6)</sup> Incorporated by reference from Bancorp's Current Report on Form 8-K filed with the Securities and Exchange Commission on March 20, 2006.

<sup>(7)</sup> Incorporated by reference from Bancorp's 2008 Proxy Statement filed with Securities and Exchange Commission on March 12, 2008.

<sup>(8)</sup> Incorporated by reference from Bancorp's Current Report on Form 8-K filed with the Securities and Exchange Commission on November 18, 2008.

<sup>(9)</sup> Incorporated by reference from Bancorp's Annual Report on Form 10-K for fiscal year ended December 31, 2009 and filed with the Securities and Exchange Commission on March 15, 2010.

<sup>(10)</sup> Incorporated by reference from Bancorp's Quarterly Report on Form 10-Q for the quarter ended June 30, 2010 and filed with the Securities and Exchange Commission on August 13, 2010.

<sup>(11)</sup> Incorporated by reference from Bancorp's Annual Report on Form 10-K for fiscal year ended December 31, 2003 and filed with the Securities and Exchange Commission on March 25, 2004.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

March 15, 2012

SEVERN BANCORP, INC.

/s/ Alan J. Hyatt

Alan J. Hyatt

Chairman of the Board, President,

Chief Executive Officer and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

March 15, 2012	<u>/s/ Alan J. Hyatt</u> Alan J. Hyatt Chairman of the Board, President, Chief Executive Officer and Director
March 15, 2012	<u>/s/ Stephen W. Lilly</u> Stephen W. Lilly, Senior Vice President, Chief Financial Officer
March 15, 2012	<u>/s/ Melvin E. Meekins, Jr.</u> Melvin E. Meekins, Jr., Vice Chairman of the Board
March 15, 2012	<u>/s/ Eric M. Keitz</u> Eric M. Keitz, Director
March 15, 2012	<u>/s/ John A. Lamon III</u> John A. Lamon III, Director
March 15, 2012	<u>/s/ Ronald P. Pennington</u> Ronald P. Pennington, Director
March 15, 2012	<u>/s/ T. Theodore Schultz</u> T. Theodore Schultz, Director
March 15, 2012	<u>/s/ Albert W. Shields</u> Albert W. Shields, Director
March 15, 2012	<u>/s/ Konrad M. Wayson</u> Konrad M. Wayson, Director



## **Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders  
Severn Bancorp, Inc.

We have audited the accompanying consolidated statements of financial condition of Severn Bancorp, Inc. and its subsidiaries (the "Company") as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Severn Bancorp, Inc. and its subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

*ParenteBeard LLC*

Lancaster, Pennsylvania  
March 15, 2012

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(dollars in thousands, except per share data)

	December 31,	
	2011	2010
<b>ASSETS</b>		
Cash and due from banks	\$35,577	\$33,339
Interest bearing deposits in other banks	40,610	20,149
Federal funds sold	11,203	17,467
Cash and cash equivalents	87,390	70,955
Investment securities held to maturity	40,357	27,311
Loans held for sale	4,128	3,426
Loans receivable, net of allowance for loan losses of \$25,938 and \$29,871 in 2011 and 2010, respectively	693,303	778,937
Premises and equipment, net	27,218	28,327
Foreclosed real estate	19,932	20,955
Federal Home Loan Bank stock at cost	6,943	7,692
Accrued interest receivable and other assets	21,357	24,940
Total assets	<u>\$900,628</u>	<u>\$962,543</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<u>Liabilities</u>		
Deposits	\$652,757	\$714,776
Long-term borrowings	115,000	115,000
Subordinated debentures	24,119	24,119
Accrued interest payable and other liabilities	2,822	2,548
Total Liabilities	<u>794,698</u>	<u>856,443</u>
<u>Stockholders' Equity</u>		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized:		
Preferred stock series "A", 437,500 shares issued and outstanding	4	4
Preferred stock series "B", 23,393 shares issued and outstanding	-	-
Common stock, \$0.01 par value, 20,000,000 shares authorized;		
10,066,679 shares issued and outstanding	101	101
Additional paid-in capital	74,683	74,352
Retained earnings	31,142	31,643
Total stockholders' equity	<u>105,930</u>	<u>106,100</u>
Total liabilities and stockholders' equity	<u>\$900,628</u>	<u>\$962,543</u>

The accompanying notes to consolidated financial statements are an integral part of these statements.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(dollars in thousands, except per share data)

	Years Ended December 31,		
	2011	2010	2009
<b><u>Interest Income</u></b>			
Loans, including fees	\$43,675	\$49,154	\$52,520
Securities, taxable	617	245	104
Other	209	134	34
Total interest income	44,501	49,533	52,658
<b><u>Interest Expense</u></b>			
Deposits	10,405	13,735	19,782
Short-term borrowings	-	-	12
Long-term borrowings and subordinated debentures	5,182	5,594	6,257
Total interest expense	15,587	19,329	26,051
Net interest income	28,914	30,204	26,607
Provision for loan losses	4,612	5,744	31,402
Net interest income (loss) after provision for loan losses	24,302	24,460	(4,795)
<b><u>Other Income</u></b>			
Mortgage banking activities	576	843	316
Real estate commissions	657	594	690
Real estate management fees	625	573	677
Other	652	735	818
Total other income	2,510	2,745	2,501
<b><u>Non-Interest Expenses</u></b>			
Compensation and related expenses	10,155	9,583	9,377
Occupancy	1,247	1,466	1,365
Foreclosed real estate expenses, net	5,409	5,518	4,883
Legal	905	1,258	1,003
FDIC assessments and regulatory expense	2,231	2,282	2,156
Other	4,664	4,901	4,078
Total non-interest expenses	24,611	25,008	22,862
Income (loss) before income tax provision (benefit)	2,201	2,197	(25,156)
Income tax provision (benefit)	982	1,040	(9,928)
Net income (loss)	\$1,219	\$1,157	\$(15,228)
Amortization of discount on preferred stock	270	270	270
Dividends on preferred stock	1,450	1,450	1,430
Net loss available to common stockholders	\$(501)	\$(563)	\$(16,928)
Basic loss per share	\$(0.05)	\$(0.06)	\$(1.68)
Diluted loss per share	\$(0.05)	\$(0.06)	\$(1.68)

The accompanying notes to consolidated financial statements are an integral part of these statements.



SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
Years Ended December 31, 2011, 2010, and 2009  
(dollars in thousands, except per share data)

	Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
Balance - December 31, 2008	\$ 4	\$101	\$73,522	\$50,040	\$123,667
Comprehensive Loss					
Net loss	-	-	-	(15,228)	(15,228)
Stock-based compensation	-	-	128	-	128
Dividends on common stock (\$0.09 per share)	-	-	-	(906)	(906)
Dividend declared on Series A preferred stock (\$.64 per share)	-	-	-	(280)	(280)
Dividend declared on Series B preferred stock	-	-	-	(1,150)	(1,150)
Amortization of discount on preferred stock	-	-	-	-	-
	-	-	270	(270)	-
Balance - December 31, 2009	4	101	73,920	32,206	106,231
Comprehensive Income					
Net income	-	-	-	1,157	1,157
Stock-based compensation	-	-	162	-	162
Dividend declared on Series A preferred stock (\$.64 per share)	-	-	-	(280)	(280)
Dividend declared on Series B preferred stock	-	-	-	(1,170)	(1,170)
Amortization of discount on preferred stock	-	-	-	-	-
	-	-	270	(270)	-
Balance - December 31, 2010	4	101	74,352	31,643	106,100
Comprehensive Income					
Net income	-	-	-	1,219	1,219
Stock-based compensation	-	-	61	-	61
Dividend declared on Series A preferred stock (\$.64 per share)	-	-	-	(280)	(280)
Dividend declared on Series B preferred stock	-	-	-	(1,170)	(1,170)
Amortization of discount on preferred stock	-	-	-	-	-
	-	-	270	(270)	-
Balance - December 31, 2011	<u>\$4</u>	<u>\$101</u>	<u>\$74,683</u>	<u>\$31,142</u>	<u>\$105,930</u>

The accompanying notes to consolidated financial statements are an integral part of these statements.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(dollars in thousands)

	Years Ended December 31,		
	2011	2010	2009
<u>Cash Flows from Operating Activities</u>			
Net income (loss)	\$1,219	\$1,157	\$(15,228)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Amortization of deferred loan fees	(1,344)	(1,463)	(2,048)
Net amortization of premiums and Discounts	170	87	3
Provision for loan losses	4,612	5,744	31,402
Provision for depreciation	1,248	1,238	1,276
Provision for foreclosed real estate	3,562	3,451	3,911
Gain on sale of loans	(575)	(843)	(316)
Loss on sale of foreclosed real estate	639	449	15
Proceeds from loans sold to others	43,276	64,916	29,616
Loans originated for sale	(43,403)	(62,654)	(33,692)
Stock-based compensation expense	61	162	128
Deferred income tax expense (benefit)	931	2,160	(9,194)
Decrease (increase) in accrued interest receivable and other assets	2,652	2,890	(8,532)
Increase (decrease) in accrued interest payable and other liabilities	274	439	(890)
Net cash provided by (used in) operating activities	13,322	17,733	(3,549)
<u>Cash Flows from Investing Activities</u>			
Purchase of investment securities held to maturity	(21,530)	(21,394)	(7,999)
Proceeds from maturing investment securities	8,000	2,000	1,000
Principal collected on mortgage-backed securities	314	27	310
Net decrease in loans	66,071	6,879	23,940
Proceeds from sale of foreclosed real estate	13,619	21,286	9,708
Investment in foreclosed real estate	(502)	(430)	(413)
Investment in premises and equipment	(139)	(461)	(137)
Proceeds from disposal of premises and Equipment	-	-	24
Redemption of FHLB stock	749	917	85
Net cash provided by investing activities	66,582	8,824	26,518

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
(dollars in thousands)

	Years Ended December 31,		
	2011	2010	2009
<u>Cash Flows from Financing Activities</u>			
Net (decrease) increase in deposits	\$(62,019)	\$4,447	\$26,463
Repayment of borrowed funds, long-term	-	(10,000)	(28,000)
Common stock dividends paid	-	-	(906)
Series "A" preferred stock dividend paid	(280)	(280)	(280)
Series "B" preferred stock dividend paid	(1,170)	(1,170)	(1,150)
Net cash used in financing activities	<u>(63,469)</u>	<u>(7,003)</u>	<u>(3,873)</u>
Increase in cash and cash equivalents	16,435	19,554	19,096
Cash and cash equivalents at beginning of year	<u>70,955</u>	<u>51,401</u>	<u>32,305</u>
Cash and cash equivalents at end of year	<u>\$87,390</u>	<u>\$70,955</u>	<u>\$51,401</u>
Supplemental disclosure of cash flows information:			
Cash paid during year for:			
Interest	<u>\$15,582</u>	<u>\$19,395</u>	<u>\$26,410</u>
Income taxes	<u>\$476</u>	<u>\$-</u>	<u>\$2,295</u>
Transfer of loans to foreclosed real estate	<u>\$16,295</u>	<u>\$24,137</u>	<u>\$28,478</u>

The accompanying notes to consolidated financial statements are an integral part of these statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies**

- A. **Principles of Consolidation** - The consolidated financial statements include the accounts of Severn Bancorp, Inc. ("Bancorp"), and its wholly-owned subsidiaries, SBI Mortgage Company and SBI Mortgage Company's subsidiary, Crownsville Development Corporation, and its subsidiary, Crownsville Holdings I, LLC, and Severn Savings Bank, FSB (the "Bank"), and the Bank's subsidiaries, Louis Hyatt, Inc., Homeowners Title and Escrow Corporation, Severn Financial Services Corporation, SSB Realty Holdings, LLC, SSB Realty Holdings II, LLC, and HS West, LLC. All intercompany accounts and transactions have been eliminated in the accompanying consolidated financial statements.

Amounts in the prior year's consolidated financial statements have been reclassified whenever necessary to conform to the current year's presentation. Such reclassifications had no impact on net income.

- B. **Business** - The Bank's primary business activity is the acceptance of deposits from the general public and the use of the proceeds for investments and loan originations. The Bank is subject to competition from other financial institutions. In addition, the Bank is subject to the regulations of certain federal agencies and undergoes periodic examinations by those regulatory authorities.

Bancorp has no reportable segments. Management does not separately allocate expenses, including the cost of funding loan demand, between the retail and real estate operations of Bancorp. As such, discrete financial information is not available and segment reporting would not be meaningful.

- C. **Estimates** - The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the statement of financial condition and revenues and expenses for the period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, the fair value of foreclosed real estate, the evaluation of other than temporary impairment of investment securities and the valuation of deferred income tax assets.

- D. **Investment Securities Held to Maturity** - Investment securities for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted for premiums and discounts that are recognized in interest income using the interest method over the period to maturity. Declines in the fair value of held to maturity securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer and (3) determines if the Bank does not intend to sell the security before recovery of its amortized cost.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies - Continued**

- E. **Federal Home Loan Bank Stock** – Federal Home Loan Bank of Atlanta (the “FHLB”) stock is an equity interest in the FHLB, which does not have a readily determinable fair value for purposes of generally accepted accounting principles, because its ownership is restricted and it lacks a market. FHLB stock can be sold back only at par value of \$100 per share and only to the FHLB or another member institution. As of December 31, 2011 and 2010, the Company owned shares totaling \$6,943,000 and \$7,692,000, respectively.

The Company evaluated the FHLB stock for impairment in accordance with generally accepted accounting principles. The Company’s determination of whether this investment is impaired is based on an assessment of the ultimate recoverability of its cost rather than by recognizing temporary declines in value. The determination of whether a decline in value affects the ultimate recoverability of its cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB and (3) the impact of legislative and regulatory changes on institutions and accordingly on the customer base of the FHLB. Management has evaluated the FHLB stock for impairment and believes that no impairment charge is necessary as of December 31, 2011.

- F. **Loans Held for Sale** - Loans held for sale are carried at lower of cost or market value in the aggregate based on investor quotes. Net unrealized losses are recognized through a valuation allowance by charges to income. Mortgage loans held for sale are sold either with the mortgage servicing rights released or retained by the Bank. Gains and losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

- G. **Loans** - Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

Residential lending is generally considered to involve less risk than other forms of lending, although payment experience on these loans is dependent to some extent on economic and market conditions in the Bank's lending area. Multifamily residential, commercial, construction and other loan repayments are generally dependent on the operations of the related properties or the financial condition of its borrower or guarantor. Accordingly, repayment of such loans can be more susceptible to adverse conditions in the real estate market and the regional economy.

A substantial portion of the Bank's loans receivable is mortgage loans secured by residential and commercial real estate properties located in the State of Maryland. Loans are extended only after evaluation by management of customers' creditworthiness and other relevant factors on a case-by-case basis. The Bank generally does not lend more than 80% of the appraised value of a property and requires private mortgage insurance on residential mortgages with loan-to-value ratios in excess of 80%.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies – Continued**

In addition, the Bank generally obtains personal guarantees of repayment from borrowers and/or others for construction, commercial and multifamily residential loans and disburses the proceeds of construction and similar loans only as work progresses on the related projects.

The accrual of interest on loans is discontinued at the time the loan is 90 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued in the current year, but not collected for loans that are placed on non-accrual or charged-off, is reversed against interest income. Any interest accrued in prior years for loans that are placed on non-accrual or charged-off is charged against the allowance for loan losses. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

- H. Allowance for Loan Losses** - An allowance for loan losses is provided through charges to income in an amount that management believes will be adequate to absorb losses on existing loans that may become uncollectible, based on evaluations of the collectability of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Determining the amount of the allowance for loan losses requires the use of estimates and assumptions, which is permitted under generally accepted accounting principles. Actual results could differ significantly from those estimates. Management believes the allowance for losses on loans is adequate. While management uses available information to estimate losses on loans, future additions to the allowances may be necessary based on changes in economic conditions, particularly in the State of Maryland. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for losses on loans. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. When a real estate secured loan becomes impaired, a decision is made as to whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies - Continued**

For such loans that are classified as impaired, an allowance is established when the current market value of the underlying collateral less its estimated disposal costs is lower than the carrying value of that loan. For loans that are not solely collateral dependent, an allowance is established when the present value of the expected future cash flows of the impaired loan is lower than the carrying value of that loan. The general component relates to loans that are classified as doubtful, substandard or special mention that are not considered impaired, as well as non-classified loans. The general reserve is based on historical loss experience adjusted for qualitative factors. These qualitative factors include:

- Levels and trends in delinquencies and nonaccruals;
- Inherent risk in the loan portfolio;
- Trends in volume and terms of the loan;
- Effects of any change in lending policies and procedures;
- Experience, ability and depth of management;
- National and local economic trends and conditions; and
- Effect of any changes in concentration of credit.

A loan is considered impaired if it meets either of the following two criteria:

- Loans that are 90 days or more in arrears (nonaccrual loans); or
- Loans where, based on current information and events, it is probable that a borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

A loan is considered a troubled debt restructuring (TDR) when Bancorp, for economic or legal reasons relating to the borrowers financial difficulties, grants a concession to the borrower that it would not otherwise consider. Loan modifications made with terms consistent with current market conditions that the borrower could obtain in the open market are not considered troubled debt restructurings.

Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies – Continued**

- I. Foreclosed Real Estate** - Real estate acquired through or in the process of foreclosure is recorded at fair value less estimated disposal costs. Management periodically evaluates the recoverability of the carrying value of the real estate acquired through foreclosure using estimates as described under the caption "Allowance for Loan Losses". In the event of a subsequent decline, management provides a specific reserve to reduce real estate acquired through foreclosure to fair value less estimated disposal cost. Expenses incurred on foreclosed real estate prior to disposition are charged to expense. Gains or losses on the sale of foreclosed real estate are recognized upon disposition of the property.
- J. Transfers of Financial Assets** – Transfers of financial assets, including loan and loan participation sales, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from Bancorp, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) Bancorp does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return the specific assets.
- K. Premises and Equipment** - Premises and equipment are carried at cost less accumulated depreciation. Depreciation and amortization of premises and equipment is accumulated by the use of the straight-line method over the estimated useful lives of the assets. Additions and improvements are capitalized, and charges for repairs and maintenance are expensed when incurred. The related cost and accumulated depreciation are eliminated from the accounts when an asset is sold or retired and the resultant gain or loss is credited or charged to income.
- L. Statement of Cash Flows** - In the statement of cash flows, cash and cash equivalents include cash on hand, amounts due from banks, Federal Home Loan Bank of Atlanta overnight deposits, and federal funds sold. Generally, federal funds are sold for one day periods.
- M. Income Taxes** - Deferred income taxes are recognized for temporary differences between the financial reporting basis and income tax basis of assets and liabilities based on enacted tax rates expected to be in effect when such amounts are realized or settled. Deferred tax assets are recognized only to the extent that it is more likely than not that such amount will be realized based on consideration of available evidence.

The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. To the extent that current available evidence about the future raises doubt about the likelihood of a deferred tax asset being realized, a valuation allowance is established. The judgment about the level of future taxable income is inherently subjective and is reviewed on a continual basis as regulatory and business factors change.

Bancorp recognizes interest and penalties on income taxes as a component of income tax expense.



SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies – Continued**

- N. Earnings Per Share** - Basic earnings (loss) per share of common stock for the years ended December 31, 2011, 2010 and 2009 is computed by dividing net income (loss) available to common stockholders by 10,066,679, the weighted average number of shares of common stock outstanding for each year. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by Bancorp relate to outstanding stock options, warrants, and convertible preferred stock, and are determined using the treasury stock method. Diluted earnings per share of common stock for the years ended December 31, 2011, 2010 and 2009, is computed by dividing net income (loss) for each year by 10,066,679, the weighted average number of diluted shares of common stock for each year.
- O. Advertising Cost** - Advertising cost is expensed as incurred and totaled \$510,000, \$422,000 and \$370,000 for the years ended December 31, 2011, 2010, and 2009, respectively.
- P. Recent Accounting Pronouncements** - In January 2011, the FASB issued ASU 2011-1, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No.2010-20* (ASU 2011-1). The FASB determined that certain provisions relating to troubled debt restructurings (TDRs) should be deferred until additional guidance and clarification on the definition of TDRs is issued.

In April 2011, the FASB issued ASU No. 2011-2, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring* (ASU 2011-2). ASU 2011-2 amends ASC Topic 310 – *Receivables*, by clarifying guidance for creditors in determining whether a concession has been granted and whether a debtor is experiencing financial difficulties. The amendments are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. ASU 2011-2 also makes disclosure requirements deferred under ASU 2011-1 effective for interim and annual periods beginning on or after June 15, 2011.

In June 2011, the FASB issued amendments to ASU No. 2011-2 to clarify the accounting principles applied to loan modifications, as defined by FASB ASC Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors*. The ASU clarifies guidance on a creditor's evaluation of whether or not a concession has been granted, with an emphasis on evaluating all aspects of the modification rather than a focus on specific criteria, such as the effective interest rate test, to determine a concession. The ASU goes on to provide guidance on specific types of modifications such as changes in the interest rate of borrowing, and significant delays in payments, as well as guidance on the creditor's evaluation of whether or not a debtor is experiencing financial difficulty. The amendments to ASU No. 2011-2 are effective for the first interim or annual periods beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The application of ASU 2011-2, as amended, did not have a material effect on the consolidated financial statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies - Continued**

In June 2011, ASU 2011-4 was issued to amend FASB ASC Topic 820, *Fair Value Measurements*, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. ASU No. 2011-4 clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. ASU No. 2011-4 also creates an exception to Topic 820 for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. ASU No. 2011-4 also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. Lastly, ASU 2011-4 contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of relationships between unobservable inputs; usage of nonfinancial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. ASU 2011-4 is effective for interim and annual periods beginning after December 15, 2011. Bancorp has evaluated the effect of ASU 2011-4, as amended, and believes adoption will not have a material effect on the consolidated financial statements.

In June 2011, ASU 2011-5 was issued to amend FASB ASC Topic 220, *Comprehensive Income*, to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. ASU No. 2011-5 prohibits the presentation of components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all three presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. The provisions of ASU No. 2011-5 are effective for fiscal years and interim periods beginning after December 15, 2011. Bancorp has evaluated the effect of ASU 2011-5, as amended, and believes adoption will not have a material effect on the consolidated financial statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies - Continued**

In September 2011, the FASB issued ASU No. 2011-8, *Testing Goodwill for Impairment*. The purpose of this ASU is to simplify how entities test goodwill for impairment by adding a new first step to the preexisting goodwill impairment test under ASC Topic 350, *Intangibles – Goodwill and Other*. This amendment gives the entity the option to first assess a variety of qualitative factors such as economic conditions, cash flows, and competition to determine whether it was more likely than not that the fair value of goodwill has fallen below its carrying value. If the entity determines that it is not likely that the fair value has fallen below its carrying value, then the entity will not have to complete the original two-step test under Topic 350. The amendments in this ASU are effective for impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. Bancorp has evaluated the effect of ASU 2011-8, as amended, and believes adoption will not have a material effect on the consolidated financial statements.

In December 2011, the FASB issued ASC 2011-10, *Derecognition of in Substance Real Estate – a Scope Clarification*. This ASU clarifies previous guidance for situations in which a reporting entity would relinquish control of the assets of a subsidiary in order to satisfy the nonrecourse debt of the subsidiary. The ASU concludes that if control of the assets has been transferred to the lender, but not legal ownership of the assets; then the reporting entity must continue to include the assets of the subsidiary in its consolidated financial statements. The amendments in the ASU are effective for public entities for annual and interim periods beginning on or after June 15, 2012. For nonpublic entities, the amendments are effective for fiscal years ending after December 15, 2013. Early adoption is permitted. Bancorp has evaluated the effect of ASU 2011-10 and believes its application has not had a material effect on the consolidated financial statements.

In December, 2011, the FASB issued ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, in an effort to improve comparability between U.S. GAAP and IFRS financial statements with regard to the presentation of offsetting assets and liabilities on the statement of financial position arising from financial and derivative instruments, and repurchase agreements. The ASU establishes additional disclosures presenting the gross amounts of recognized assets and liabilities, offsetting amounts, and the net balance reflected in the statement of financial position. Descriptive information regarding the nature and rights of the offset must also be disclosed when effective. Bancorp has evaluated the effect of ASU 2011-11, and believes adoption will not have a material effect on the consolidated financial statements.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 - Summary of Significant Accounting Policies - Continued**

In December, 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update 2011-5*. In response to stakeholder concerns regarding the operational ramifications of the presentation of these reclassifications for current and previous years, the FASB has deferred the implementation date of this provision to allow time for further consideration. The requirement in ASU 2011-5, *Presentation of Comprehensive Income*, for the presentation of a combined statement of comprehensive income or separate, but consecutive, statements of net income and other comprehensive income is still effective for fiscal years and interim periods beginning after December 15, 2011 for public companies, and fiscal years ending after December 15, 2011 for nonpublic companies. Bancorp is evaluating the impact of this ASU 2011-12 on its consolidated financial statements.

- Q. Subsequent Events** – Bancorp has evaluated events and transactions occurring subsequent to December 31, 2011, the date of the consolidated statements of financial condition, for items that should potentially be recognized or disclosed in the consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.
- R. Concentration of Credit Risk** – From time to time, the Bank will maintain balances with its correspondent bank that exceed the \$250,000 federally insured deposit limit. Management routinely evaluates the credit worthiness of the correspondent bank and does not feel they pose a significant risk to Bancorp.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 2 - Investment Securities**

The amortized cost and fair value of investment securities held to maturity are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(dollars in thousands)			
<u>December 31, 2011:</u>				
US Treasury securities	\$34,498	\$1,285	\$(5)	\$35,778
US Agency securities	5,206	43	(4)	5,245
US Government sponsored mortgage-backed securities	653	48	-	701
Total	<u>\$40,357</u>	<u>\$1,376</u>	<u>\$(9)</u>	<u>\$41,724</u>
<u>December 31, 2010:</u>				
US Treasury securities	\$21,104	\$223	\$(2)	\$21,325
US Agency securities	5,233	-	(37)	5,196
US Government sponsored mortgage-backed securities	974	61	-	1,035
Total	<u>\$27,311</u>	<u>\$284</u>	<u>\$(39)</u>	<u>\$27,556</u>

As of December 31, 2011 and 2010, there were \$6,432,000 and \$8,760,000, respectively, of US Treasury securities or mortgage-backed securities pledged by Bancorp as collateral for borrowers' letters of credit with Anne Arundel County.

The following tables show fair value and unrealized losses, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position as of December 31, 2011 and 2010. Included in the table for 2011 are two US Treasury securities and one US Agency security. Management believes that the unrealized losses are the result of interest rate levels differing from those existing at the time of purchase of the securities and actual and estimated prepayment speeds. The Bank does not consider any of these securities to be other than temporarily impaired at December 31, 2011, because the unrealized losses are related primarily to changes in market interest rates and widening of sector spreads and are not necessarily related to the underlying credit quality of the issuers of the securities.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 2 - Investment Securities – Continued**

In addition, the Bank does not intend to sell, nor does it believe that it will more likely than not be required to sell, any impaired securities prior to a recovery of amortized cost.

	Less than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
(dollars in thousands)						
<u>December 31, 2011:</u>						
US Treasury securities	\$2,046	\$(5)	\$-	\$(-)	\$2,046	\$(5)
US Agency securities	1,032	(4)	-	(-)	1,032	(4)
Total	<u>\$3,078</u>	<u>\$(9)</u>	<u>\$-</u>	<u>\$(-)</u>	<u>\$3,078</u>	<u>\$(9)</u>
<u>December 31, 2010:</u>						
US Treasury securities	\$1,033	\$(2)	\$-	\$(-)	\$1,033	\$(2)
US Agency securities	5,196	(37)	-	(-)	5,196	(37)
Total	<u>\$6,229</u>	<u>\$(39)</u>	<u>\$-</u>	<u>\$(-)</u>	<u>\$6,229</u>	<u>\$(39)</u>

The amortized cost and estimated fair value of debt securities as of December 31, 2011, by contractual maturity, are shown in the following table. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Held to Maturity (dollars in thousands)	
	Amortized Cost	Estimated Fair Value
Due in one year or less	\$ 7,000	\$ 7,035
Due from one year to five years	27,610	28,451
Due from five years to ten years	5,094	5,537
US Government sponsored	653	701
Mortgage-backed securities	<u>\$40,357</u>	<u>\$41,724</u>

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable**

Loans receivable consist of the following:

	December 31	
	2011	2010
	(dollars in thousands)	
<b>Residential mortgage, total</b>	\$295,876	\$326,255
Individually evaluated for impairment	51,007	59,189
Collectively evaluated for impairment	244,869	267,066
<b>Construction, land acquisition and development, total</b>	99,122	144,098
Individually evaluated for impairment	35,398	21,937
Collectively evaluated for impairment	63,724	122,161
<b>Land, total</b>	59,649	63,155
Individually evaluated for impairment	11,384	10,196
Collectively evaluated for impairment	48,265	52,959
<b>Lines of credit, total</b>	34,278	36,642
Individually evaluated for impairment	5,735	4,564
Collectively evaluated for impairment	28,543	32,078
<b>Commercial real estate, total</b>	203,010	212,477
Individually evaluated for impairment	24,354	23,683
Collectively evaluated for impairment	178,656	188,794
<b>Commercial non-real estate, total</b>	5,599	8,434
Individually evaluated for impairment	32	305
Collectively evaluated for impairment	5,567	8,129
<b>Home equity, total</b>	41,309	43,501
Individually evaluated for impairment	2,340	975
Collectively evaluated for impairment	38,969	42,526
<b>Consumer, total</b>	897	1,302
Individually evaluated for impairment	24	61
Collectively evaluated for impairment	873	1,241
<b>Total Loans</b>	739,740	835,864
Individually evaluated for impairment	130,274	120,910
Collectively evaluated for impairment	609,466	714,954
<b>Less</b>		
Loans in process	(18,014)	(23,851)
Allowance for loan losses	(25,938)	(29,871)
Deferred loan origination fees and costs, net	(2,485)	(3,205)
	<u>\$693,303</u>	<u>\$778,937</u>

SEVERN BANCORP, INC. AND SUBSIDIARIES  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 3 - Loans Receivable - Continued**

The following is a summary of the allowance for loan losses for the years ended December 31, 2011, 2010 and 2009 (dollars in thousands):

2011	Total	Residential Mortgage	Acquisition and Development	Land	Lines of Credit	Commercial Real Estate	Commercial Non-Real Estate	Home Equity	Consumer
Beginning Balance	\$29,871	\$16,339	\$3,997	\$4,225	\$458	\$3,949	\$131	\$762	\$10
Provision	4,612	385	1,422	(766)	267	1,019	38	1,534	713
Charge-offs	(8,545)	(4,421)	(1,503)	(1,054)	(-)	(811)	(-)	(39)	(717)
Recoveries	-	-	-	-	-	-	-	-	-
Ending Balance	<u>\$25,938</u>	<u>\$12,303</u>	<u>\$3,916</u>	<u>\$2,405</u>	<u>\$725</u>	<u>\$4,157</u>	<u>\$169</u>	<u>\$2,257</u>	<u>\$6</u>
Loans individually evaluated for impairment	\$12,994	\$5,509	\$2,624	\$1,365	\$510	\$960	\$28	\$1,998	\$-
Loans collectively evaluated for impairment	\$12,944	\$6,794	\$1,292	\$1,040	\$215	\$3,197	\$141	\$259	\$6
<b>2010</b>									
Beginning Balance	\$34,693	\$19,621	\$1,492	\$5,539	\$20	\$5,506	\$82	\$2,425	\$8
Provision	5,744	3,443	2,505	1,782	438	(1,034)	49	(1,446)	7
Charge-offs	(10,666)	(6,825)	(-)	(3,096)	(-)	(523)	(-)	(217)	(5)
Recoveries	100	100	-	-	-	-	-	-	-
Ending Balance	<u>\$29,871</u>	<u>\$16,339</u>	<u>\$3,997</u>	<u>\$4,225</u>	<u>\$458</u>	<u>\$3,949</u>	<u>\$131</u>	<u>\$762</u>	<u>\$10</u>
Loans individually evaluated for impairment	\$14,540	\$8,149	\$2,645	\$2,282	\$264	\$766	\$-	\$434	\$-
Loans collectively evaluated for impairment	\$15,331	\$8,190	\$1,352	\$1,943	\$194	\$3,183	\$131	\$328	\$10
<b>2009</b>									
Beginning Balance	\$14,813								
Provision	31,402								
Charge-offs	(11,579)								
Recoveries	57								
Ending Balance	<u>\$34,693</u>								



SEVERN BANCORP, INC. AND SUBSIDIARIES  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 3 - Loans Receivable - Continued**

The allowance for loan losses is based on management's judgment and evaluation of the loan portfolio. Management assesses the adequacy of the allowance for loan losses and the need for any addition thereto, by considering the nature and size of the loan portfolio, overall portfolio quality, review of specific problem loans, economic conditions that may affect the borrowers' ability to pay or the value of property securing loans, and other relevant factors. While management believes the allowance was adequate as of December 31, 2011, changing economic and market conditions may require future adjustments to the allowance for loan losses.

The following table presents Bancorp's non-performing assets as of December 31, 2011 and December 31, 2010 (dollars in thousands):

	December 31, 2011	Number of loans	December 31, 2010	Number of loans
Loans accounted for on a non-accrual basis:				
Residential mortgage	\$8,912	25	\$18,778	46
Home equity	343	3	118	2
Lines of credit	2,019	4	4,265	8
Commercial real estate	2,140	5	1,927	6
Acquisition and development	10,997	11	15,160	17
Land	6,813	14	5,890	21
Commercial non-real estate	5	1	-	-
Consumer	203	4	26	2
Total non-accrual loans	\$31,432	67	\$46,164	102
Accruing loans greater than 90 days past due	\$-		\$ -	
Foreclosed real-estate	\$19,932		\$20,955	
Total non-performing assets	\$51,364		\$67,119	
Total troubled debt restructurings	\$59,775	115	\$72,029	135
Total non-accrual loans to net loans	4.5%		5.9%	
Allowance for loan losses	\$25,938		\$29,871	
Allowance to total loans	3.6%		3.7%	
Allowance for loan losses to total non-performing loans, including loans contractually past due 90 days or more	82.5%		64.7%	
Total non-accrual and accruing loans greater than 90 days past due to total assets	3.5%		4.8%	
Total non-performing assets to total assets	5.7%		7.0%	

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

The following tables summarize impaired loans at December 31, 2011 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Allowance	Recorded Investment	Recorded Investment	Unpaid Principal Balance
<b>December 31, 2011</b>					
Residential mortgage	\$26,736	\$5,509	\$24,271	\$51,007	\$50,310
Home equity	2,170	1,998	170	2,340	2,340
Lines of credit	1,548	510	4,187	5,735	5,735
Commercial real estate	4,694	960	19,660	24,354	24,354
Acquisition and development	18,023	2,624	17,375	35,398	34,535
Land	2,850	1,365	8,534	11,384	9,949
Commercial non-real estate	28	28	4	32	32
Consumer	-	-	24	24	24
Total Impaired loans	\$56,049	\$12,994	\$74,225	\$130,274	\$127,279

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>December 31, 2011</b>						
Residential mortgage	\$26,826	\$1,080	\$25,659	\$1,201	\$52,485	\$2,281
Home equity	1,772	66	170	4	1,942	70
Lines of credit	590	87	4,187	143	4,777	230
Commercial real estate	4,723	191	19,821	1,185	24,544	1,376
Acquisition and development	19,968	793	19,199	696	39,167	1,489
Land	3,770	236	9,143	261	12,913	497
Commercial non-real estate	28	-	5	-	33	-
Consumer	-	-	23	-	23	-
Total Impaired loans	\$57,677	\$2,453	\$78,207	\$3,490	\$135,884	\$5,943

Changes in impaired loans during 2011 are as follows (dollars in thousands):

Impaired loans at December 31, 2010	\$120,910
Added to impaired loans	53,134
Gross loans transferred to foreclosed real estate	(19,820)
Paid off prior to foreclosure	(23,950)
Impaired loans at December 31, 2011	<u>\$130,274</u>

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

The following tables summarize impaired loans at December 31, 2010 (dollars in thousands):

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance	Total Impaired Loans	
	Recorded Investment	Related Investment	Recorded Investment	Recorded Investment	Unpaid Principal Balance
<b>December 31, 2010</b>					
Residential mortgage	\$38,251	\$8,149	\$20,938	\$59,189	\$59,189
Home equity	568	434	407	975	975
Lines of credit	836	264	3,728	4,564	4,564
Commercial real estate	3,975	766	19,708	23,683	23,683
Acquisition and development	17,273	2,645	4,664	21,937	21,937
Land	6,567	2,282	3,629	10,196	10,196
Commercial non-real estate	-	-	305	305	305
Consumer	-	-	61	61	61
Total Impaired loans	\$67,470	\$14,540	\$53,440	\$120,910	\$120,910

	Impaired Loans with Specific Allowance		Impaired Loans with No Specific Allowance		Total Impaired Loans	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>December 31, 2010</b>						
Residential mortgage	\$39,382	\$1,508	\$21,611	\$1,057	\$60,993	\$2,565
Home equity	568	21	407	17	975	38
Lines of credit	985	167	3,294	115	4,279	282
Commercial real estate	4,034	248	19,838	1,420	23,872	1,668
Acquisition and development	19,327	1,212	5,307	303	24,634	1,515
Land	6,572	288	3,772	492	10,344	780
Commercial non-real estate	-	-	900	45	900	45
Consumer	-	-	61	-	61	-
Total Impaired loans	\$70,868	\$3,444	\$55,190	\$3,449	\$126,058	\$6,893

Changes in impaired loans during 2010 are as follows (dollars in thousands):

Impaired loans at December 31, 2009	\$122,941
Added to impaired loans	62,025
Gross loans transferred to foreclosed real estate	(32,283)
Paid off prior to foreclosure	(31,773)
Impaired loans at December 31, 2010	\$120,910

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

Included in the above impaired loans amount at December 31, 2011 is \$98,842,000 of loans that are not in non-accrual status. In addition, there was a total of \$51,007,000 of residential real estate loans included in impaired loans at December 31, 2011, of which \$43,768,000 were to consumers and \$7,239,000 to builders. The collateral supporting impaired loans is individually reviewed by management to determine its estimated fair market value, less estimated disposal cost and a specific allowance is established, if necessary, for the difference between the carrying amount of any loan and the estimated fair value of the collateral less estimated disposal cost.

Of the impaired loans, \$56,049,000 and \$67,470,000 had a specific valuation allowance of \$12,994,000 and \$14,540,000 at December 31, 2011 and 2010, respectively. Impaired loans averaged \$135,884,000 during 2011, \$126,058,000 during 2010 and \$105,484,000 during 2009. Interest income recognized on these loans totaled \$5,943,000 during 2011, \$6,893,000 during 2010 and \$4,073,000 during 2009.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard and Doubtful within the internal risk rating system as of December 31, 2011 and 2010 (dollars in thousands):

	Pass	Special Mention	Substandard	Doubtful	Total
<b>December 31, 2011</b>					
Residential mortgage	\$259,359	\$8,624	\$27,689	\$204	\$295,876
Home equity	38,456	712	2,141	-	41,309
Lines of credit	27,067	1,708	5,503	-	34,278
Commercial real estate	180,635	10,702	11,673	-	203,010
Acquisition and development	62,054	6,521	30,547	-	99,122
Land	44,443	4,909	10,297	-	59,649
Commercial non-real estate	5,567	-	4	28	5,599
Consumer	874	-	23	-	897
Total loans	<u>\$618,455</u>	<u>\$33,176</u>	<u>\$87,877</u>	<u>\$232</u>	<u>\$739,740</u>
	Pass	Special Mention	Substandard	Doubtful	Total
<b>December 31, 2010</b>					
Residential mortgage	\$281,027	\$9,999	\$35,229	\$-	\$326,255
Home equity	41,030	1,497	974	-	43,501
Lines of credit	28,979	2,796	4,867	-	36,642
Commercial real estate	197,031	3,667	11,779	-	212,477
Acquisition and development	105,052	13,481	25,565	-	144,098
Land	48,384	5,708	9,063	-	63,155
Commercial non-real estate	8,091	38	305	-	8,434
Consumer	1,243	-	59	-	1,302
Total loans	<u>\$710,837</u>	<u>\$37,186</u>	<u>\$87,841</u>	<u>\$-</u>	<u>\$835,864</u>

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

Interest income that would have been recorded under the original terms of non-accrual loans and the interest income actually recognized for the years ended December 31, are summarized below (dollars in thousands):

	2011	2010	2009
Interest income that would have been recorded	\$2,905	\$4,905	\$4,588
Interest income recognized	822	2,599	1,271
Interest income not recognized	<u>\$2,083</u>	<u>\$2,306</u>	<u>\$3,317</u>

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the aging categories of performing loans and nonaccrual loans as of December 31, 2011 and 2010 (dollars in thousands):

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non- Accrual	Total Loans
<b>December 31, 2011</b>							
Residential mortgage	\$272,543	\$9,696	\$4,725	\$-	\$14,421	\$8,912	\$295,876
Home equity	40,021	945	-	-	945	343	41,309
Lines of credit	32,221	-	38	-	38	2,019	34,278
Commercial real estate	198,049	2,535	286	-	2,821	2,140	203,010
Acquisition and development	87,756	369	-	-	369	10,997	99,122
Land	51,094	1,517	225	-	1,742	6,813	59,649
Commercial non-real estate	5,584	10	-	-	10	5	5,599
Consumer	694	-	-	-	-	203	897
Total Impaired loans	<u>\$687,962</u>	<u>\$15,072</u>	<u>\$ 5,274</u>	<u>\$-</u>	<u>\$20,346</u>	<u>\$31,432</u>	<u>\$739,740</u>

	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days+ Past Due	Total Past Due	Non- Accrual	Total Loans
<b>December 31, 2010</b>							
Residential mortgage	\$297,793	\$5,028	\$4,656	\$-	\$9,684	\$18,778	\$326,255
Home equity	43,138	115	130	-	245	118	43,501
Lines of credit	29,465	854	2,058	-	2,912	4,265	36,642
Commercial real estate	206,434	3,058	1,058	-	4,116	1,927	212,477
Acquisition and development	122,858	1,950	4,130	-	6,080	15,160	144,098
Land	52,492	3,865	908	-	4,773	5,890	63,155
Commercial non-real estate	8,434	-	-	-	-	-	8,434
Consumer	1,272	4	-	-	4	26	1,302
Total Impaired loans	<u>\$761,886</u>	<u>\$14,874</u>	<u>\$12,940</u>	<u>\$-</u>	<u>\$27,814</u>	<u>\$46,164</u>	<u>\$835,864</u>

Mortgage loans serviced for others not included in the accompanying consolidated statements of financial condition totaled \$84,745,000 and \$82,082,000 at December 31, 2011 and 2010, respectively.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
Annapolis, Maryland  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable – Continued**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated statements of financial condition. The contract amounts of these instruments express the extent of involvement the Bank has in each class of financial instruments.

The Bank's exposure to credit loss from non-performance by the other party to the above mentioned financial instruments is represented by the contractual amount of those instruments.

The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Unless otherwise noted, the Bank requires collateral or other security to support financial instruments with off-balance-sheet credit risk.

Financial Instruments Whose Contract Amounts Represent Credit Risk	Contract Amount At December 31,	
	2011	2010
	(dollars in thousands)	
Standby letters of credit	\$15,319	\$17,959
Home equity lines of credit	14,623	14,340
Unadvanced construction commitments	18,014	26,662
Mortgage loan commitments	1,059	5,827
Lines of credit	31,525	25,833
Loans sold with limited repurchase provisions	\$17,558	\$37,943

Standby letters of credit are conditional commitments issued by the Bank guaranteeing performance by a customer to various municipalities. These guarantees are issued primarily to support performance arrangements, limited to real estate transactions. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2011 and 2010 for guarantees under standby letters of credit issued is not material.

Home equity lines of credit are loan commitments to individuals as long as there is no violation of any condition established in the contract. Commitments under home equity lines expire ten years after the date the loan closes and are secured by real estate. The Bank evaluates each customer's credit worthiness on a case-by-case basis.

Unadvanced construction commitments are loan commitments made to borrowers for both residential and commercial projects that are either in process or are expected to begin construction shortly.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 3 - Loans Receivable – Continued**

Mortgage loan commitments not reflected in the accompanying statements of financial condition at December 31, 2011 include \$1,059,000 at a fixed interest rate range of 3.25% to 5.50% and none at floating interest rates.

Lines of credit are loan commitments to individuals and companies as long as there is no violation of any condition established in the contract. Lines of credit have a fixed expiration date. The Bank evaluates each customer's credit worthiness on a case-by-case basis.

The Bank has entered into several agreements to sell mortgage loans to third parties. The loans sold under these agreements for the years ended December 31, 2011, 2010 and 2009 were \$43,403,000, \$59,113,000 and \$31,346,000, respectively. These agreements contain limited provisions that require the Bank to repurchase a loan if the loan becomes delinquent within the terms specified by the agreement. The credit risk involved in these financial instruments is essentially the same as that involved in extending loan facilities to customers. No amount has been recognized in the consolidated statement of financial condition at December 31, 2011 and 2010 as a liability for credit loss related to these loans. The Bank had to repurchase one loan under these agreements in 2011.

Bancorp has not purchased, sold or reclassified any loans to held for sale during the periods discussed. Only loans originated specifically for sale are recorded as held for sale at the period ended December 31, 2011 and December 31, 2010.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
Annapolis, Maryland  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

Bancorp offers a variety of modifications to borrowers. The modification categories offered can generally be described in the following categories:

- Rate Modification – A modification in which the interest rate is changed.
- Term Modification – A modification in which the maturity date, timing of payments or frequency of payments is changed.
- Interest Only Modification – A modification in which the loan is converted to interest only payments for a period of time.
- Payment Modification – A modification in which the dollar amount of the payment is changed, other than an interest only modification above.
- Combination Modification – Any other type of modification, including the use of multiple categories above.

Bancorp considers a modification of a loan term a TDR if Bancorp for economic or legal reasons related to the borrower's financial difficulties grants a concession to the debtor that it would not otherwise consider. Prior to entering into a loan modification, Bancorp assesses the borrower's financial condition to determine if the borrower has the means to meet the terms of the modification. This includes obtaining a credit report on the borrower as well as the borrower's tax returns and financial statements.

The following tables summarize troubled debt restructurings at December 31, 2011 (dollars in thousands):

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Residential mortgage	68	\$30,372	\$29,815
Home equity	-	-	-
Lines of credit	2	332	332
Commercial real estate	8	8,215	8,046
Acquisition and development	8	11,152	10,260
Land	9	3,985	3,802
Commercial non-real estate	-	-	-
Consumer	-	-	-
Total loans	<u>95</u>	<u>\$54,056</u>	<u>\$52,255</u>
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings That Subsequently Defaulted:			
Residential mortgage	14	\$4,568	\$4,542
Home equity	-	-	-
Lines of credit	1	140	140
Commercial real estate	1	288	286
Acquisition and development	1	2,090	2,090
Land	3	464	462
Commercial non-real estate	-	-	-
Consumer	-	-	-
Total loans	<u>20</u>	<u>\$7,550</u>	<u>\$7,520</u>



**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 3 - Loans Receivable - Continued**

The following tables present newly restructured loans that occurred during the year ended December 31, 2011 (dollars in thousands):

	Year ended December 31, 2011					
	Rate Modification	Contracts	Combination Modifications	Contracts	Total	Total Contracts
Pre-Modification Outstanding Recorded Investment:						
Residential mortgage	\$817	2	\$22,282	43	\$23,099	45
Home equity	-	-	-	-	-	-
Lines of credit	-	-	332	2	332	2
Commercial real estate	262	1	7,427	6	7,689	7
Acquisition and development	3,930	1	5,580	5	9,510	6
Land	552	1	1,927	6	2,479	7
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	\$5,561	5	\$37,548	62	\$43,109	67
Post-Modification Outstanding Recorded Investment:						
Residential mortgage	\$738	2	\$21,861	43	\$22,599	45
Home equity	-	-	-	-	-	-
Lines of credit	-	-	332	2	332	2
Commercial real estate	262	1	7,433	6	7,695	7
Acquisition and development	3,930	1	4,914	5	8,844	6
Land	551	1	1,916	6	2,467	7
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	\$5,481	5	\$36,456	62	\$41,937	67

In addition, the collateral securing the TDR, which is always real estate, is evaluated for impairment based on either an appraisal or broker price opinion. If the borrower performs under the terms of the modification, and the ultimate collectability of all amounts contractually due under the modified terms is not in doubt, the loan is returned to accrual status. There are no loans that have been modified due to the financial difficulties of the borrower that are not considered a TDR.

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**Note 3 - Loans Receivable – Continued**

Interest on TDRs was accounted for under the following methods as of December 31, 2011 and December 31, 2010 (dollars in thousands):

	Number of Contracts	Accrual Status	Number of Contracts	Non- Accrual Status	Total Number of Contracts	Total Modifications
December 31, 2011						
Residential mortgage	57	\$22,820	25	\$11,537	82	\$34,357
Home equity	-	-	-	-	-	-
Lines of credit	1	140	2	332	3	472
Commercial real estate	5	3,169	4	5,163	9	8,332
Acquisition and development	8	11,962	1	388	9	12,350
Land	6	2,333	6	1,931	12	4,264
Commercial non-real estate	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total loans	77	\$40,424	38	\$19,351	115	\$59,775
December 31, 2010						
Total loans	88	\$39,834	47	\$32,195	135	\$72,029

Management does not charge off a TDR, or a portion of a TDR, until one of the following conditions has been met:

- The loan has been foreclosed on. Once the loan has been transferred from the Loans Receivable to Foreclosed Real Estate, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.
- An agreement to accept less than the face value of the loan has been made with the borrower. Once an agreement has been finalized, and any proceeds from the borrower are received, a charge off is recorded for the difference between the recorded amount of the loan and the net value of the underlying collateral.

Prior to either of the above conditions, a loan is assessed for impairment when a loan becomes a TDR. If, based on management's assessment of the underlying collateral of the loan, it is determined that a reserve is needed, a specific reserve is recorded. That reserve is included in the Allowance for Loan Losses in the Consolidated Statement of Financial Condition.

Bancorp performs A note/B note workout structures as a subset of Bancorp's troubled debt restructuring strategy. The amount of loans restructured using this structure were \$1,505,000 and \$0 as of December 31, 2011 and December 31, 2010, respectively.

Under an A note/B note workout structure, the new A note is underwritten in accordance with customary troubled debt restructuring underwriting standards and is reasonably assured of full repayment while the B note is not. The B note is immediately charged off upon restructuring.

If the loan was on accrual status prior to the troubled debt restructuring being documented with the loan legally bifurcated into an A note fully supporting accrual status and a B note or amount contractually forgiven and charged off, the A note may remain on accrual status. If the loan was on nonaccrual status at the time the troubled debt restructuring was documented with the loan legally bifurcated into an A note fully supporting accrual status and a B note or amount contractually forgiven and fully charged off, the A note may be returned to accrual status, and risk rated accordingly, after a reasonable period of performance under the troubled debt restructuring terms. Six months of payment performance is generally required to return these loans to accrual status.

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**Note 3 - Loans Receivable - Continued**

The A note will continue to be classified as a troubled debt restructuring and may only be removed from impaired status in years after the restructuring if (a) the restructuring agreement specifies an interest rate equal to or greater than the rate that Bancorp was willing to accept at the time of the restructuring for a new loan with a comparable risk and (b) the loan is not impaired based on the terms specified by the restructuring agreement.

**Note 4 - Premises and Equipment**

Premises and equipment are summarized by major classification as follows:

	December 31,		Estimated
	2011	2010	Useful Lives
	(dollars in thousands)		
Land	\$1,537	\$1,537	-
Building	29,028	29,023	39 Years
Leasehold improvements	1,206	1,161	15-27.5 Years
Furniture, fixtures and equipment	3,232	3,143	3-10 Years
Total at cost	35,003	34,864	
Accumulated depreciation	(7,785)	(6,537)	
	<u>\$27,218</u>	<u>\$28,327</u>	

Depreciation expense was \$1,248,000, \$1,238,000, and \$1,276,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

Bancorp has four retail branch locations in Anne Arundel County, Maryland, of which it owns three and leases the fourth from a third party. The initial lease term expired July 2010 and the first option to renew for an additional five year term was exercised. There is an option remaining to renew the lease for one more additional five year term. In addition, the Bank leases office space in Annapolis, Maryland from a third party. The lease expires January 2016, with the option to renew the lease for one additional five year term.

The minimum future annual rental payments on leases are as follows:

<u>Years Ended December 31, (in thousands)</u>	
2012	\$96
2013	97
2014	97
2015	72
2016	3
Thereafter	-

Total rent expense was \$96,000, \$95,000, and \$94,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

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**Note 5 – Foreclosed Real Estate**

As of December 31, 2011, Bancorp had foreclosed real estate consisting of 57 residential properties with a carrying value of \$19,932,000. During the year ended December 31, 2011, Bancorp sold a total of 60 properties previously included in foreclosed real estate. The properties sold during 2011 had a combined net book value of \$14,258,000 after total write-downs taken subsequent to their transfer from loans to foreclosed real estate of \$2,691,000, and were sold at a combined net loss of \$639,000. In addition, Bancorp incurred \$1,179,000 in expenses related to the sale of the properties. The following table summarizes the changes in foreclosed real estate for the years ended December 31, 2011, 2010 and 2009 (dollars in thousands):

Foreclosed real estate at December 31, 2008	\$ 6,317
Transferred from impaired loans, net of specific reserves of \$7,453	28,478
Property improvements	413
Additional write downs	(3,911)
Property sold, including loss on sale	(9,723)
Foreclosed real estate at December 31, 2009	21,574
Transferred from impaired loans, net of specific reserves of \$8,146	24,137
Property improvements	430
Additional write downs	(3,451)
Property sold, including loss on sale	(21,735)
Foreclosed real estate at December 31, 2010	20,955
Transferred from impaired loans, net of specific reserves of \$3,584	16,295
Property improvements	502
Additional write downs	(3,562)
Property sold, including loss on sale	(14,258)
Foreclosed real estate at December 31, 2011	<u>\$19,932</u>

**Note 6 - Investment in Federal Home Loan Bank of Atlanta Stock**

The Bank is required to maintain an investment in the stock of the Federal Home Loan Bank of Atlanta ("FHLB") in an amount equal to at least 1% of the unpaid principal balances of the Bank's residential mortgage loans or 1/20 of its outstanding advances from the FHLB, whichever is greater. Purchases and sales of stock are made directly with the FHLB at par value.

**Note 7 – Deposits**

Deposits in the Bank as of December 31, 2011 and 2010 consisted of the following:

Category	2011		2010	
	Amount	Percent	Amount	Percent
	(dollars in thousands)			
NOW accounts	\$16,654	2.55%	\$13,465	1.88%
Money market accounts	43,344	6.64%	41,168	5.76%
Passbooks	189,696	29.06%	222,183	31.08%
Certificates of deposit	383,103	58.69%	420,133	58.78%
Non-interest bearing accounts	19,960	3.06%	17,827	2.50%
Total deposits	<u>\$652,757</u>	<u>100.00%</u>	<u>\$714,776</u>	<u>100.00%</u>

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**Note 7 – Deposits - continued**

At December 31, 2011 scheduled maturities of certificates of deposit are as follows:

	Amount
	(dollars in thousands)
One year or less	\$254,873
More than 1 year to 2 years	83,412
More than 2 years to 3 years	20,757
More than 3 years to 4 years	7,977
More than 4 years to 5 years	16,084
	<u>\$383,103</u>

The aggregate amount of jumbo certificates of deposit with a minimum denomination of \$100,000 was \$164,877,000 and \$185,716,000 at December 31, 2011 and 2010, respectively.

Interest expense on deposits is summarized as follows (dollars in thousands):

	For Years Ended December 31,		
	2011	2010	2009
NOW accounts	\$54	\$52	\$65
Money market accounts	273	405	626
Passbooks	1,567	2,982	2,589
Certificates of deposit	8,511	10,296	16,502
	<u>\$10,405</u>	<u>\$13,735</u>	<u>\$19,782</u>

**Note 8 - Federal Home Loan Bank Advances**

The Bank's credit availability under the FHLB of Atlanta's credit availability program was \$184,400,000 and \$194,360,000 at December 31, 2011 and 2010, respectively. The Bank is able to borrow up to 20% of total assets. There were no short-term borrowings with the FHLB at December 31, 2011 and 2010. Long-term advances outstanding were \$115,000,000 at both December 31, 2011 and 2010. The maturities of these long-term advances at December 31, 2011 are as follows (dollars in thousands):

Rate	Amount	Maturity
-%	\$ -	2012
-%	-	2013
2.940% to 4.210%	25,000	2014
3.710% to 4.340%	40,000	2015
-%	-	2016
2.580% to 4.050%	50,000	Thereafter
	<u>\$115,000</u>	

The Bank's stock in the FHLB of Atlanta is pledged as security for the advances and under a blanket floating lien security agreement with the FHLB of Atlanta. The Bank is required to maintain as collateral for its advances, qualified loans in varying amounts depending on the loan type. Loans with an approximate fair value of \$217,706,000 are pledged as collateral at December 31, 2011.

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**Note 9 - Subordinated Debentures**

As of December 31, 2011, Bancorp had outstanding approximately \$20,619,000 principal amount of Junior Subordinated Debt Securities Due 2035 (the "2035 Debentures"). The 2035 Debentures were issued pursuant to an Indenture dated as of December 17, 2004 (the "2035 Indenture") between Bancorp and Wells Fargo Bank, National Association as Trustee. The 2035 Debentures pay interest quarterly at a floating rate of interest of 3-month LIBOR (0.40% December 31, 2011) plus 200 basis points, and mature on January 7, 2035. Payments of principal, interest, premium and other amounts under the 2035 Debentures are subordinated and junior in right of payment to the prior payment in full of all senior indebtedness of Bancorp, as defined in the 2035 Indenture. The 2035 Debentures became redeemable, in whole or in part, by Bancorp on January 7, 2010.

The 2035 Debentures were issued and sold to Severn Capital Trust I (the "Trust"), of which 100% of the common equity is owned by Bancorp. The Trust was formed for the purpose of issuing corporation-obligated mandatorily redeemable Capital Securities ("Capital Securities") to third-party investors and using the proceeds from the sale of such Capital Securities to purchase the 2035 Debentures. The 2035 Debentures held by the Trust are the sole assets of the Trust. Distributions on the Capital Securities issued by the Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Trust on the 2035 Debentures. The Capital Securities are subject to mandatory redemption, in whole or in part, upon repayment of the 2035 Debentures. Bancorp has entered into an agreement which, taken collectively, fully and unconditionally guarantees the Capital Securities subject to the terms of the guarantee. \$17,000,000 of the proceeds from Bancorp's issuance of the debentures was contributed to the Bank, and qualifies as Tier 1 capital for the Bank under Federal Reserve Board guidelines.

On November 15, 2008, Bancorp completed a private placement offering consisting of a total of 70 units, at an offering price of \$100,000 per unit, for gross proceeds of \$7.0 million. Each unit consisted of 6,250 shares of Bancorp's Series A 8.0% Non-Cumulative Convertible Preferred Stock and Bancorp's Subordinated Note in the original principal amount of \$50,000.

The Subordinated Notes earn interest at an annual rate of 8.0%, payable quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. The Subordinated Notes are redeemable in whole or in part at the option of Bancorp at any time beginning on December 31, 2009 until maturity, which is December 31, 2018. Debt issuance costs totaled \$245,000 and are being amortized over 10 years.

**Note 10 – Employee Benefit Plans**

The Bank has a 401(k) Retirement Savings Plan. Employees may contribute a percentage of their salary up to the maximum amount allowed by law. The Bank is obligated to contribute 50% of the employee's contribution, not to exceed 6% of the employee's annual salary. All employees who have completed one year of service with the Bank are eligible to participate. The Bank's contribution to this plan was \$139,000, \$127,000 and \$130,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

The Bank has an Employee Stock Ownership Plan ("ESOP") for the exclusive benefit of participating employees. The Bank recognized ESOP expense of \$140,000 for the years ended December 31, 2011, 2010 and 2009, and had unallocated shares to participants in the plan totaling 47,500, 29,807 and 2,100 as of December 31, 2011, 2010 and 2009, respectively. The fair value of the unallocated shares at December 31, 2011 was \$117,000.

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**Note 11 - Stockholders' Equity**

As part of the private placement offering discussed in Note 9, Bancorp issued a total of 437,500 shares of its Series A 8.0% Non-Cumulative Convertible Preferred Stock ("Series A Preferred Stock"). The liquidation preference is \$8.00 per share. Holders of Series A Preferred Stock will not be entitled to any further liquidation distribution on the Series A Preferred Stock. Each share of Series A Preferred Stock is convertible at the option of the holder into one share of Bancorp common stock, subject to adjustment upon certain corporate events. The initial conversion rate is equivalent to an initial conversion price of \$8.00 per share of Bancorp common stock. At the option of Bancorp, on and after December 31, 2013, at any time and from time to time, some or all of the Series A Preferred Stock may be converted into shares of Bancorp common stock at the then-applicable conversion rate. Costs related to the issuance of the preferred stock totaled \$247,000 and were netted against the proceeds.

If declared by Bancorp's board of directors, cash dividends at an annual rate of 8.0% will be paid quarterly in arrears on the last day of March, June, September and December commencing December 31, 2008. Dividends will not be paid on Bancorp common stock in any quarter until the dividend on the Series A Preferred Stock has been paid for such quarter; however, there is no requirement that Bancorp's board of directors declare any dividends on the Series A Preferred Stock and any unpaid dividends shall not be cumulative.

On November 21, 2008, Bancorp entered into an agreement with the United States Department of the Treasury ("Treasury"), pursuant to which Bancorp issued and sold (i) 23,393 shares of its Series B Fixed Rate Cumulative Perpetual Preferred Stock, par value \$0.01 per share and liquidation preference \$1,000 per share, (the "Series B Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 556,976 shares of Bancorp's common stock, par value \$0.01 per share, for an aggregate purchase price of \$23,393,000. Costs related to the issuance of the preferred stock and warrants totaled \$45,000 and were netted against the proceeds.

The Series B Preferred Stock qualifies as Tier 1 capital and will pay cumulative compounding dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series B Preferred Stock may be redeemed by Bancorp after three years. Prior to the end of three years, the Series B Preferred Stock may not be redeemed by Bancorp except with proceeds from one or more Qualified Equity Offerings, as defined in the Purchase Agreement.

The Series B Preferred Stock has no maturity date and ranks pari passu with Bancorp's existing Series A Preferred Stock, in terms of dividend payments and distributions upon liquidation, dissolution and winding up of Bancorp.

The Series B Preferred Stock is non-voting, other than class voting rights on certain matters that could adversely affect the Series B Preferred Stock. If dividends on the Series B Preferred Stock have not been paid for an aggregate of six quarterly dividend periods or more, whether consecutive or not, Bancorp's authorized number of directors will be automatically increased by two and the holders of the Series B Preferred Stock, voting together with holders of any then outstanding voting parity stock, will have the right to elect those directors at Bancorp's next annual meeting of stockholders or at a special meeting of stockholders called for that purpose. These preferred share directors will be elected annually and serve until all accrued and unpaid dividends on the Series B Preferred Stock have been paid.

The Warrant has a 10-year term and is immediately exercisable at an exercise price of \$6.30 per share of Common Stock. The exercise price and number of shares subject to the Warrant are both subject to anti-dilution adjustments. Pursuant to the Purchase Agreement, Treasury has agreed not to exercise voting power with respect to any shares of Common Stock issued upon exercise of the Warrant.

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**Note 11 - Stockholders' Equity - Continued**

Bancorp's ability to declare dividends on its common stock are limited by the terms of Bancorp's Series A preferred stock and Series B preferred stock. Bancorp may not declare or pay any dividend on, make any distributions relating to, or redeem, purchase, acquire or make a liquidation payment relating to, or make any guarantee payment with respect to its common stock in any quarter until the dividend on the Series A Preferred Stock has been declared and paid for such quarter, subject to certain minor exceptions. Additionally, Bancorp may not declare or pay dividend or distribution on its common stock, and Bancorp may not purchase, redeem or otherwise acquire for consideration any of its common stock, unless all accrued and unpaid dividends for all past dividend periods, including the latest completed dividend period, on all outstanding shares of Series B preferred stock have been or are contemporaneously declared and paid in full (or have been declared and a sum sufficient for the payment thereof has been set aside), subject to certain minor exceptions.

Additionally, under the terms of Bancorp's 2035 Debentures, if (i) there has occurred and is continuing an event of default, (ii) Bancorp is in default with respect to payment of any obligations under the related guarantee or (iii) Bancorp has given notice of its election to defer payments of interest on the 2035 Debentures by extending the interest distribution period as provided in the indenture governing the 2035 Debentures and such period, or any extension thereof, has commenced and is continuing, then Bancorp may not, among other things, declare or pay any dividends or distributions on, or redeem, purchase, acquire, or make a liquidation payment with respect to, any of its capital stock, including common stock.

**Note 12- Stock-Based Compensation**

Bancorp has a stock-based compensation plan for directors, officers, and other key employees of Bancorp. The aggregate number of shares of common stock that may be issued with respect to the awards granted under the plan is 500,000 plus any shares forfeited under Bancorp's old stock-based compensation plan. Under the terms of the plan, Bancorp has the ability to grant various stock compensation incentives, including stock options, stock appreciation rights, and restricted stock. The stock-based compensation is granted under terms and conditions determined by the Compensation Committee of the Board of Directors. Under the stock based compensation plan, stock options generally have a maximum term of ten years, and are granted with an exercise price at least equal to the fair market value of the common stock on the date the options are granted. Generally, options granted to directors of Bancorp vest immediately, and options granted to officers and employees vest over a five-year period, although the Compensation Committee has the authority to provide for different vesting schedules.

Bancorp follows FASB ASC 718, Compensation – Stock Compensation (FASB ASC 718) to account for stock-based compensation. FASB ASC 718 requires all share-based payments to employees, including grants of employee stock options, to be recognized as compensation expense in the statement of operations at fair value. FASB ASC 718 requires an entity to recognize the expense of employee services received in share-based payment transactions and measure the expense based on the grant date fair value of the award. The expense is recognized over the period during which an employee is required to provide service in exchange for the award. Stock-based compensation expense included in the consolidated statements of operations for the years ended December 31, 2011, 2010 and 2009 totaled \$61,000, \$162,000 and \$128,000, respectively. There was no income tax benefit recognized in the consolidated statements of operations for stock-based compensation for the years ended December 31, 2011, 2010 and 2009.

There were 0 options granted in 2011, 100,000 options granted in 2010 and 0 options granted in 2009.



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**Note 12- Stock-Based Compensation – Continued**

Information regarding Bancorp's stock option plan as of and for the years ended December 31, 2011, 2010 and 2009 is as follows:

	Shares	Weighted Average Price	Weighted Average Remaining Life	Aggregate Intrinsic Value
Options outstanding, December 31, 2008	114,950	\$ 15.87		
Options granted	-	-		
Options exercised	-	-		
Options forfeited	(4,235)	15.62		
Options outstanding, December 31, 2009	110,715	15.88		\$-
Options granted	100,000	4.21		
Options exercised	-	-		
Options forfeited	(19,965)	15.62		
Options outstanding, December 31, 2010	190,750	9.79		\$-
Options granted	-	-		
Options exercised	-	-		
Options forfeited	(90,750)	15.93		
Options outstanding, December 31, 2011	100,000	\$ 4.21	4.21	\$-
Options exercisable, December 31, 2011	35,834	\$ 4.21	3.21	\$-
Option price range at December 31, 2011	\$4.13 to \$4.54			

The stock-based compensation expense amounts were derived using the Black-Scholes option-pricing model. The following weighted average assumptions were used to value options granted in current and prior periods presented.

	2011	2010	2009
Expected life of options	5.00 years	4.91 years	4.83 years
Risk-free interest rate	2.37%	3.60%	4.59%
Expected volatility	58.78%	55.94%	53.66%
Expected dividend yield	-%	2.52%	4.54%

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because Bancorp's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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**Note 12- Stock-Based Compensation – Continued**

The following table summarizes the nonvested options in Bancorp's stock option plan as of December 31, 2011.

	Shares	Weighted Average Grant Date Fair Value
Nonvested options outstanding, December 31, 2010	86,949	\$4.59
Nonvested options granted	-	-
Nonvested options vested	(20,000)	4.21
Nonvested options forfeited	(2,783)	15.93
Nonvested options outstanding, December 31, 2011	64,166	\$4.21

As of December 31, 2011, there was \$136,000 of total unrecognized stock-based compensation cost related to non-vested stock options, which is expected to be recognized over a period of thirty-nine months.

**Note 13- Regulatory Matters**

The Bank is required to maintain an average daily balance with the Federal Reserve Bank in a non-interest bearing account. The amount in such account at December 31, 2011 was \$300,000.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary, actions by the regulators that, if undertaken, could have a direct material effect on the Bancorp's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2011, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2011, the most recent notification from the regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table.

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**Note 13- Regulatory Matters – Continued**

The following table presents the Bank's actual capital amounts and ratios at December 31, 2011 and 2010:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	%	Amount	%	Amount	%
	(dollars in thousands)					
<u>December 31, 2011</u>						
Tangible (1)	\$115,224	13.0%	\$13,345	1.50%	N/A	N/A
Tier I capital (2)	115,224	17.1%	N/A	N/A	\$40,292	6.00%
Core (1)	115,224	13.0%	35,586	4.00%	44,482	5.00%
Total (2)	123,626	18.4%	53,723	8.00%	67,154	10.00%
<u>December 31, 2010</u>						
Tangible (1)	\$117,733	12.3%	\$14,340	1.50%	N/A	N/A
Tier I capital (2)	117,733	15.6%	N/A	N/A	\$45,342	6.00%
Core (1)	117,733	12.3%	38,240	4.00%	47,800	5.00%
Total (2)	127,175	16.8%	60,456	8.00%	75,570	10.00%

(1) To adjusted total assets.

(2) To risk-weighted assets.

On November 23, 2009, Bancorp and the Bank entered into supervisory agreements with their regulators. The agreements require, among other things, in accordance with specific guidelines set forth in the agreements, that the Bank revise its policies regarding problem assets, revise its allowance for loan and lease losses policies, revise policies and procedures for the use of interest reserves, develop and implement a program for managing risks associated with concentrations of credit, revise its loan modification policy and furnish written quarterly progress reports to its regulators detailing the actions taken to comply with the agreements. In addition, Bancorp and the Bank must obtain prior regulatory approval before any dividends or capital distributions can be made. Bancorp's main source of income is dividends from the Bank. As a result, Bancorp's dividends to its shareholders will depend primarily upon receipt of dividends from the Bank and compliance with the supervisory agreements. Management believes that Bancorp and the Bank are in compliance with these agreements at December 31, 2011.

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**Note 14 - Income Taxes**

The income tax provision (benefit) consists of the following for the years ended December 31:

	<u>2011</u>	<u>2010</u>	<u>2009</u>
	(dollars in thousands)		
<u>Current</u>			
Federal	\$28	(\$1,005)	(\$617)
State	<u>23</u>	<u>(115)</u>	<u>(117)</u>
	51	(1,120)	(734)
<u>Deferred</u>			
Federal	660	1,741	(7,342)
State	<u>271</u>	<u>419</u>	<u>(1,852)</u>
	931	2,160	(9,194)
Total income tax provision (benefit)	<u>\$982</u>	<u>\$1,040</u>	<u>(\$9,928)</u>

The amount computed by applying the statutory federal income tax rate to income (loss) before taxes is less than the tax provision (benefit) for the following reasons for the years ended December 31:

	<u>2011</u>		<u>2010</u>		<u>2009</u>	
	<u>Amount</u>	<u>Percent of Pretax Income</u>	<u>Amount</u>	<u>Percent of Pretax Income</u>	<u>Amount</u>	<u>Percent of Pretax (Loss)</u>
	(dollars in thousands)					
Statutory Federal income tax rate	\$748	34.0%	\$747	34.0%	(\$8,553)	34.0%
State tax net of Federal income tax benefit	182	8.3%	201	9.1%	(1,384)	5.5%
Other adjustments	<u>52</u>	<u>2.3%</u>	<u>92</u>	<u>4.2%</u>	<u>9</u>	<u>0%</u>
	<u>\$982</u>	<u>44.6%</u>	<u>\$1,040</u>	<u>47.3%</u>	<u>(\$9,928)</u>	<u>39.5%</u>

Bancorp does not have any unrecognized tax benefits at December 31, 2011 or 2010.

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**Note 14 - Income Taxes - Continued**

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2011 and 2010 are presented below:

	2011	2010
	(dollars in thousands)	
Deferred Tax Assets:		
Allowance for loan losses	\$10,468	\$12,057
Reserve on foreclosed real estate	1,420	1,146
Reserve for uncollected interest	540	676
Federal net operating loss carryforwards	639	-
State net operating loss carryforwards	278	188
Other	104	69
Total deferred tax assets	13,449	14,136
Valuation allowance	(216)	(167)
Total deferred tax assets, net of valuation allowance	13,233	13,969
Deferred Tax Liabilities:		
Federal Home Loan Bank stock dividends	(84)	(84)
Loan origination costs	(321)	(382)
Accelerated depreciation	(1,437)	(1,273)
Prepaid expenses	(199)	(107)
Total deferred tax liabilities	(2,041)	(1,846)
Net deferred tax assets	\$11,192	\$12,123

The valuation allowance relates to state net operating loss carryforwards of \$4,036,000 and \$3,122,000 at December 31, 2011 and 2010, respectively, for which realizability is uncertain. At December 31, 2011 and 2010, Bancorp had state net operating loss carryforwards of approximately \$5,187,000 and \$3,518,000, respectively, which were available to offset state taxable income, and expire at various dates through 2031. Bancorp also had federal net operating loss carryforwards of approximately \$1,826,000 at December 31, 2011 which were available to offset federal taxable income, and expire in 2031.

In assessing the realizability of federal or state deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and prudent, feasible and permissible as well as available tax planning strategies in making this assessment. Based on the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible as well as available tax planning strategies, management believes it is more likely than not that Bancorp will realize the benefits of these deferred tax assets.

The statute of limitations for Internal Revenue Service examination of Bancorp's federal consolidated tax returns remains open for tax years 2008 through 2011.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 15 - Related Party Transactions**

During the years ended December 31, 2011, 2010 and 2009, the Bank engaged in the transactions described below with parties that may be deemed affiliated.

During January, 2007, a law firm, in which the President of Bancorp and the Bank is a partner, entered into a five year lease agreement with a subsidiary of Bancorp. The term of the lease is five years with the option to renew the lease for three additional five year terms. The total lease payments received by the subsidiary were \$372,000, \$375,000 and \$405,000 for the years ended December 31, 2011, 2010 and 2009, respectively. In addition, the law firm represents Bancorp and the Bank in certain legal matters. The fees for services rendered by that firm were \$827,000, \$830,000 and \$769,000 for the years ended December 31, 2011, 2010 and 2009, respectively.

**Note 16 - Fair Value of Financial Instruments**

A fair value hierarchy that prioritizes the inputs to valuation methods is used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair market hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 16 - Fair Value of Financial Instruments – Continued**

The following table summarizes the valuation of assets re-measured at fair value on a nonrecurring basis, as of December 31, 2011 and 2010 (dollars in thousands):

Fair Value Measurement at December 31, 2011				
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Impaired loans	\$43,055	-	-	\$43,055
Foreclosed real estate	19,932	-	-	19,932

Fair Value Measurement at December 31, 2010				
	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Impaired loans	\$52,930	-	-	\$52,930
Foreclosed real estate	20,955	-	-	20,955

There were no liabilities that were required to be re-measured on a nonrecurring basis as of December 31, 2011 or 2010.

The following information should not be interpreted as an estimate of the fair value of Bancorp since a fair value calculation is only provided for a limited portion of Bancorp's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between Bancorp's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of Bancorp's financial instruments at December 31, 2011 and 2010.

***Cash and cash equivalents:***

The carrying amounts reported in the consolidated statements of financial condition for cash and cash equivalents approximate those assets' fair values.

***Investment Securities:***

Bancorp utilizes a third party source to determine the fair value of its securities. The methodology consists of pricing models based on asset class and includes available trade, bid, other market information, broker quotes, proprietary models, various databases and trading desk quotes. All Bancorp's investments are considered Level 1.

***FHLB stock:***

The carrying amount of FHLB stock approximates fair value based on the redemption provisions of the FHLB. There have been no identified events or changes in circumstances that may have a significant adverse effect on the FHLB stock. Based on our evaluation, we have concluded that our FHLB stock was not impaired at December 31, 2011 and 2010.

***Loans held for sale:***

The fair value of loans held for sale is based primarily on investor quotes.

SEVERN BANCORP, INC. AND SUBSIDIARIES  
Annapolis, Maryland  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 16 - Fair Value of Financial Instruments – Continued**

***Loans receivable:***

The fair values of loans receivable was estimated using discounted cash flow analyses, using market interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. These rates were used for each aggregated category of loans as reported on the Office of Thrift Supervision Quarterly Report.

Impaired loans are those for which Bancorp has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consisted of the loan balances of \$56,049,000 and \$67,470,000 at December 31, 2011 and 2010, respectively, less their valuation allowances of \$12,994,000 and \$14,540,000 at December 31, 2011 and 2010, respectively.

***Foreclosed Real Estate:***

Real estate acquired through foreclosure is included in the following disclosure at the lower of carrying value or fair value less estimated disposal costs. Management periodically evaluates the recoverability of the carrying value of the real estate acquired through foreclosure using current estimates of fair value. In the event of a subsequent decline, management provides a specific allowance to reduce real estate acquired through foreclosure to fair value less estimated disposal cost. Expenses incurred on foreclosed real estate prior to disposition are charged to expense. Gains or losses on the sale of foreclosed real estate are recognized upon disposition of the property.

***Accrued interest receivable and payable:***

The carrying amounts of accrued interest receivable and accrued interest payable approximates its fair value.

***Deposit liabilities:***

The fair values disclosed for demand deposit accounts, savings accounts and money market deposits are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

***FHLB advances:***

Fair values of long-term debt are estimated using discounted cash flow analysis, based on rates currently available for advances from the FHLB with similar terms and remaining maturities.

***Subordinated debentures:***

Current economic conditions have rendered the market for this liability inactive. As such, Bancorp is unable to determine a good estimate of fair value. Since the rate paid on the debentures held is lower than what would be required to secure an interest in the same debt at year end and we are unable to obtain a current fair value, Bancorp has disclosed that the carrying value approximates the fair value.

***Off-balance sheet financial instruments:***

Fair values for Bancorp's off-balance sheet financial instruments (lending commitments and letters of credit) are not significant and are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.



SEVERN BANCORP, INC. AND SUBSIDIARIES  
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 16 - Fair Value of Financial Instruments – Continued**

The following table summarizes the roll forward of level 3 assets for the years ended December 31, 2011, 2010 and 2009 (dollars in thousands):

	Impaired Loans	Foreclosed Real Estate
Balance at December 31, 2008	\$32,043	\$6,317
Transfer to foreclosed real estate	(22,850)	28,478
Additions	77,889	413
(Increase) decrease in additional reserves	(10,093)	(3,911)
Paid off/sold	(26,597)	(9,723)
Balance at December 31, 2009	50,403	21,574
Transfer to foreclosed real estate	(26,526)	24,137
Additions	59,212	430
(Increase) decrease in additional reserves	944	(3,451)
Paid off/sold	(31,103)	(21,735)
Balance at December 31, 2010	\$52,930	\$20,955
Transfer to foreclosed real estate	(14,155)	16,295
Additions	40,029	502
(Increase) decrease in additional reserves	1,545	(3,562)
Paid off/sold	(37,294)	(14,258)
Balance at December 31, 2011	<u>\$43,055</u>	<u>\$19,932</u>

The \$1,545,000 in reduced reserves recorded against impaired loans was included in the provision for loan losses on the statement of operations for the year ended December 31, 2011. The \$3,562,000 of additional reserves recorded against foreclosed real estate was included in non-interest expenses on the statement of operations for the year ended December 31, 2011. Included in the \$16,295,000 of loans transferred to foreclosed real estate, were 13 loans totaling \$5,134,000 that did not require a specific reserve at the date of transfer from loans to foreclosed real estate.

The \$944,000 in reduced reserves recorded against impaired loans was included in the provision for loan losses on the statement of operations for the year ended December 31, 2010. The \$3,451,000 of additional reserves recorded against foreclosed real estate was included in non-interest expenses on the statement of operations for the year ended December 31, 2010. Included in the \$24,137,000 of loans transferred to foreclosed real estate, were 22 loans totaling \$7,197,000 that did not require a specific reserve at the date of transfer from loans to foreclosed real estate.

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
Annapolis, Maryland  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 16 - Fair Value of Financial Instruments – Continued**

The estimated fair values of Bancorp's financial instruments are as follows:

	December 31, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(dollars in thousands)			
<u>Financial Assets</u>				
Cash and cash equivalents	\$87,390	\$87,390	\$70,955	\$70,955
Investment securities	40,357	41,724	27,311	27,556
Loans held for sale	4,128	4,128	3,426	3,426
Loans receivable, net	693,303	743,668	778,937	819,864
FHLB stock	6,943	6,943	7,692	7,692
Accrued interest receivable	3,420	3,420	3,918	3,918
<u>Financial Liabilities</u>				
Deposits	\$652,757	\$656,854	\$714,776	\$719,142
FHLB advances	115,000	102,260	115,000	105,546
Subordinated debentures	24,119	24,119	24,119	24,119
Accrued interest payable	699	699	694	694
<u>Off Balance Sheet Commitments</u>	\$ -	\$ -	\$ -	\$ -

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
**Annapolis, Maryland**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 17 - Condensed Financial Information (Parent Company Only)**

Information as to the financial position of Severn Bancorp, Inc. as of December 31, 2011 and 2010 and results of operations and cash flows for each of the years ended December 31, 2011, 2010 and 2009 is summarized below.

	December 31,	
	2011	2010
	(dollars in thousands)	
Statements of Financial Condition		
Cash	\$1,346	\$1,857
Equity in net assets of subsidiaries:		
Bank	122,141	120,258
Non-Bank	4,728	5,633
Loans, net of allowance for loan losses of \$19 and \$232, respectively	607	947
Other assets	1,341	1,632
Total assets	<u>\$130,163</u>	<u>\$130,327</u>
Subordinated debentures	\$24,119	\$24,119
Other liabilities	114	108
Total liabilities	<u>24,233</u>	<u>24,227</u>
Stockholders' equity	105,930	106,100
Total liabilities and stockholders' equity	<u>\$130,163</u>	<u>\$130,327</u>

	For the Years Ended December 31,		
	2011	2010	2009
	(dollars in thousands)		
Statements of Operations			
Interest income	\$ 82	\$ 65	\$ 76
Interest expense on subordinated debentures	772	899	880
Net interest expense	(690)	(834)	(804)
Dividends received from subsidiaries	-	-	1,567
General and administrative expenses	13	386	599
Income (loss) before income taxes and equity in undistributed net income (loss) of subsidiaries	(703)	(1,220)	164
Income tax (expense) benefit	(55)	528	342
Equity in undistributed net income (loss) of subsidiaries	1,977	1,849	(15,734)
Net income (loss)	\$1,219	\$1,157	(\$15,228)

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 17 - Condensed Financial Information (Parent Company Only) - Continued**

	For the Years Ended December 31,		
	2011	2010	2009
	(dollars in thousands)		
Statements of Cash Flows			
<u>Cash Flows from Operating Activities:</u>			
Net income (loss)	\$1,219	\$1,157	(\$15,228)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Equity in undistributed (earnings) loss of subsidiaries	(1,977)	(1,849)	15,734
Provision for loan losses	-	-	209
(Increase) decrease in other assets	290	(314)	(1)
Stock-based compensation expense	61	162	128
Increase (decrease) in other liabilities	6	-	(646)
Cash provided by (used in) operating activities	<u>(401)</u>	<u>(844)</u>	<u>196</u>
<u>Cash Flows from Investing Activities:</u>			
Net decrease in loans	340	-	2
Contribution from (investment in) subsidiaries	1,000	-	(2,000)
Cash provided by (used in) investing activities	<u>1,340</u>	<u>-</u>	<u>(1,998)</u>
<u>Cash Flows from Financing Activities:</u>			
Dividends paid on common stock	-	-	(906)
Series A preferred stock dividend paid	(280)	(280)	(280)
Series B preferred stock dividend paid	(1,170)	(1,170)	(1,150)
Cash used in financing activities	<u>(1,450)</u>	<u>(1,450)</u>	<u>(2,336)</u>
Decrease in cash and cash equivalents	(511)	(2,294)	(4,138)
Cash and cash equivalents at beginning of year	<u>1,857</u>	<u>4,151</u>	<u>8,289</u>
Cash and cash equivalents at end of year	<u>\$1,346</u>	<u>\$1,857</u>	<u>\$4,151</u>

**SEVERN BANCORP, INC. AND SUBSIDIARIES**  
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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 18 - Quarterly Financial Data (Unaudited)**

Summarized unaudited quarterly financial data for the year ended December 31, 2011 is as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share data)			
Interest income	\$11,698	\$11,254	\$10,991	\$10,558
Interest expense	4,126	3,946	3,856	3,659
Net interest income	7,572	7,308	7,135	6,899
Provision for loan losses	634	2,987	850	141
Net interest income after provision for loan losses	6,938	4,321	6,285	6,758
Other income	562	447	628	873
Other expenses	6,709	6,171	5,959	5,772
Income (loss) before income tax provision (benefit)	791	(1,403)	954	1,859
Income tax provision (benefit)	344	(557)	403	792
Net income (loss)	\$447	\$(846)	\$551	\$1,067
Per share data:				
Earnings (loss) – basic	\$0.00	\$(.13)	\$0.01	\$0.06
Earnings (loss) – diluted	\$0.00	\$(.13)	\$0.01	\$0.06

Summarized unaudited quarterly financial data for the year ended December 31, 2010 is as follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands, except per share data)			
Interest income	\$12,596	\$13,045	\$12,083	\$11,809
Interest expense	4,980	4,995	4,906	4,448
Net interest income	7,616	8,050	7,177	7,361
Provision for loan losses	2,544	1,000	1,000	1,200
Net interest income after provision for loan losses	5,072	7,050	6,177	6,161
Other income	563	537	724	921
Other expenses	6,464	6,533	6,031	5,980
Income (loss) before income tax provision (benefit)	(829)	1,054	870	1,102
Income tax provision (benefit)	(301)	461	385	495
Net income (loss)	\$(528)	\$593	\$485	\$607
Per share data				
Earnings (loss) – basic	\$(.10)	\$0.02	\$0.01	\$0.02
Earnings (loss) – diluted	\$(.10)	\$0.02	\$0.01	\$0.02

**Subsidiaries of Severn Bancorp, Inc.**

The following is a list of subsidiaries of Severn Bancorp, Inc. at December 31, 2011. All entities listed below are subsidiaries of Severn Bancorp, Inc. and, if indented, subsidiaries of the entity under which they are listed.

**Entity****Jurisdiction of Formation**

Severn Savings Bank, FSB.

United States of America (federally chartered savings association)

Louis Hyatt, Inc. (d/b/a Hyatt Commercial)

Maryland

HS West, LLC

Maryland

Severn Financial Services Corporation

Maryland

SSB Realty Holdings, LLC

Maryland

SSB Realty Holdings II, LLC

Maryland

Homeowners Title and Escrow Corporation

Maryland

SBI Mortgage Company

Maryland

Crownsville Development Corporation (d/b/a Annapolis Equity Group)

Maryland

Crownsville Holdings I, LLC

Maryland

**Consent of Independent Registered Public Accounting Firm**

Severn Bancorp, Inc.  
Annapolis, Maryland

We hereby consent to the incorporation by reference in the Registration Statements on Form S-3 (No. 333-156343) and Forms S-8 (No. 333-152657 and No. 333-133242) of our report dated March 15, 2012, relating to the consolidated financial statements of Severn Bancorp, Inc. appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

*ParenteBeard LLC*

Lancaster, Pennsylvania  
March 15, 2012

## Certification of Principal Executive Officer

I, Alan J. Hyatt, certify that:

- 1) I have reviewed this annual report on Form 10-K of Severn Bancorp, Inc.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2012

/s/ Alan J. Hyatt  
President and Chief Executive Officer



## Certification of Principal Financial Officer

I, Stephen W. Lilly, certify that:

- 1) I have reviewed this annual report on Form 10-K of Severn Bancorp, Inc.;
- 2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4) The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5) The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 15, 2012

/s/ Stephen W. Lilly

Senior Vice President, Chief Financial Officer

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code), each of the undersigned officers of Severn Bancorp, Inc. ("Bancorp") does hereby certify with respect to the Annual Report of Bancorp on Form 10-K for the period ended December 31, 2011 (the "Report") that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Bancorp.

SEVERN BANCORP, INC.

Date: March 15, 2012

/s/ Alan J. Hyatt  
Alan J. Hyatt, President, Chief Executive Officer  
and Chairman of the Board  
(Principal Executive Officer)

Date: March 15, 2012

/s/ Stephen W. Lilly  
Stephen W. Lilly, Senior Vice President,  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

The foregoing certification is being furnished solely pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Section 1350 of Chapter 63 of Title 18 of the United States Code) and is not being filed as part of the Report or as a separate disclosure document.

CERTIFICATION  
PURSUANT TO 31 C.F.R. § 30.15

I, Alan J. Hyatt, certify, based on my knowledge, that:

(i) The compensation committee of Severn Bancorp, Inc. ("Bancorp") has discussed, reviewed, and evaluated with senior risk officers at least every six months during any part of the most recently completed fiscal year that was a TARP period, senior executive officer (SEO) compensation plans and employee compensation plans and the risks these plans pose to Bancorp;

(ii) The compensation committee of Bancorp has identified and limited during any part of the most recently completed fiscal year that was a TARP period any features of the SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of Bancorp and has identified any features of the employee compensation plans that pose risks to Bancorp and has limited those features to ensure that Bancorp is not unnecessarily exposed to risks;

(iii) The compensation committee has reviewed, at least every six months during any part of the most recently completed fiscal year that was a TARP period, the terms of each employee compensation plan and identified any features of the plan that could encourage the manipulation of reported earnings of Bancorp to enhance the compensation of an employee, and has limited any such features;

(iv) The compensation committee of Bancorp will certify to the reviews of the SEO compensation plans and employee compensation plan required under (i) and (iii) above;

(v) The compensation committee of Bancorp will provide a narrative description of how it limited during any part of the most recently completed fiscal year that was a TARP period the features in

(A) SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of Bancorp;

(B) Employee compensation plans that unnecessarily expose Bancorp to risks; and

(C) Employee compensation plans that could encourage the manipulation of reported earnings of Bancorp to enhance the compensation of an employee;

(vi) Bancorp has required that bonus payments to SEOs or any of the next twenty most highly compensated employees, as defined in the regulations and guidance established under section 111 of EESA (bonus payments), be subject to a recovery or "clawback" provision during any part of the most recently completed fiscal year that was a TARP period if the bonus payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;

(vii) Bancorp has prohibited any golden parachute payment, as defined in the regulations and guidance established under section 111 of EESA, to a SEO or any of the next five most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(viii) Bancorp has limited bonus payments to its applicable employees in accordance with

section 111 of EESA and the regulations and guidance established thereunder during any part of the most recently completed fiscal year that was a TARP period;

(ix) Bancorp and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA, during any part of the most recently completed fiscal year that was a TARP period; and any expenses that, pursuant to the policy, required approval of the board of directors, a committee of the board of directors, an SEO, or an executive officer with a similar level of responsibility were properly approved;

(x) Bancorp will permit a non-binding shareholder resolution in compliance with any applicable federal securities rules and regulations on the disclosures provided under the federal securities laws related to SEO compensation paid or accrued during any part of the most recently completed fiscal year that was a TARP period;

(xi) Bancorp will disclose the amount, nature, and justification for the offering, during any part of the most recently completed fiscal year that was a TARP period, of any perquisites, as defined in the regulations and guidance established under section 111 of EESA, whose total value exceeds \$25,000 for any employee who is subject to the bonus payment limitations identified in paragraph (viii);

(xii) Bancorp will disclose whether Bancorp, the board of directors of Bancorp, or the compensation committee of Bancorp has engaged during any part of the most recently completed fiscal year that was a TARP period a compensation consultant; and the services the compensation consultant or any affiliate of the compensation consultant provided during this period;

(xiii) Bancorp has prohibited the payment of any gross-ups, as defined in the regulations and guidance established under section 111 of EESA, to the SEOs and the next twenty most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(xiv) Bancorp has substantially complied with all other requirements related to employee compensation that are provided in the agreement between Bancorp and Treasury, including any amendments;

(xv) Bancorp has submitted to Treasury a complete and accurate list of the SEOs and the twenty next most highly compensated employees for the current fiscal year, with the non-SEO's ranked in descending order of level of annual compensation, and with the name, title, and employer of each SEO and most highly compensated employee identified; and

(xvi) I understand that a knowing and willful false or fraudulent statement made in connection with this certification may be punished by fine, imprisonment, or both. (See, for example 18 USC 1001).

March 15, 2012

/s/ Alan J. Hyatt  
President and Chief Executive Officer  
(Principal Executive Officer)

CERTIFICATION  
PURSUANT TO 31 C.F.R. § 30.15

I, Stephen W. Lilly, certify, based on my knowledge, that:

(i) The compensation committee of Severn Bancorp, Inc. ("Bancorp") has discussed, reviewed, and evaluated with senior risk officers at least every six months during any part of the most recently completed fiscal year that was a TARP period, senior executive officer (SEO) compensation plans and employee compensation plans and the risks these plans pose to Bancorp;

(ii) The compensation committee of Bancorp has identified and limited during any part of the most recently completed fiscal year that was a TARP period any features of the SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of Bancorp and has identified any features of the employee compensation plans that pose risks to Bancorp and has limited those features to ensure that Bancorp is not unnecessarily exposed to risks;

(iii) The compensation committee has reviewed, at least every six months during any part of the most recently completed fiscal year that was a TARP period, the terms of each employee compensation plan and identified any features of the plan that could encourage the manipulation of reported earnings of Bancorp to enhance the compensation of an employee, and has limited any such features;

(iv) The compensation committee of Bancorp will certify to the reviews of the SEO compensation plans and employee compensation plan required under (i) and (iii) above;

(v) The compensation committee of Bancorp will provide a narrative description of how it limited during any part of the most recently completed fiscal year that was a TARP period the features in

(A) SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of Bancorp;

(B) Employee compensation plans that unnecessarily expose Bancorp to risks; and

(C) Employee compensation plans that could encourage the manipulation of reported earnings of Bancorp to enhance the compensation of an employee;

(vi) Bancorp has required that bonus payments to SEOs or any of the next twenty most highly compensated employees, as defined in the regulations and guidance established under section 111 of EESA (bonus payments), be subject to a recovery or "clawback" provision during any part of the most recently completed fiscal year that was a TARP period if the bonus payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria;

(vii) Bancorp has prohibited any golden parachute payment, as defined in the regulations and guidance established under section 111 of EESA, to a SEO or any of the next five most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(viii) Bancorp has limited bonus payments to its applicable employees in accordance with

section 111 of EESA and the regulations and guidance established thereunder during any part of the most recently completed fiscal year that was a TARP period;

(ix) Bancorp and its employees have complied with the excessive or luxury expenditures policy, as defined in the regulations and guidance established under section 111 of EESA, during any part of the most recently completed fiscal year that was a TARP period; and any expenses that, pursuant to the policy, required approval of the board of directors, a committee of the board of directors, an SEO, or an executive officer with a similar level of responsibility were properly approved;

(x) Bancorp will permit a non-binding shareholder resolution in compliance with any applicable federal securities rules and regulations on the disclosures provided under the federal securities laws related to SEO compensation paid or accrued during any part of the most recently completed fiscal year that was a TARP period;

(xi) Bancorp will disclose the amount, nature, and justification for the offering, during any part of the most recently completed fiscal year that was a TARP period, of any perquisites, as defined in the regulations and guidance established under section 111 of EESA, whose total value exceeds \$25,000 for any employee who is subject to the bonus payment limitations identified in paragraph (viii);

(xii) Bancorp will disclose whether Bancorp, the board of directors of Bancorp, or the compensation committee of Bancorp has engaged during any part of the most recently completed fiscal year that was a TARP period a compensation consultant; and the services the compensation consultant or any affiliate of the compensation consultant provided during this period;

(xiii) Bancorp has prohibited the payment of any gross-ups, as defined in the regulations and guidance established under section 111 of EESA, to the SEOs and the next twenty most highly compensated employees during any part of the most recently completed fiscal year that was a TARP period;

(xiv) Bancorp has substantially complied with all other requirements related to employee compensation that are provided in the agreement between Bancorp and Treasury, including any amendments;

(xv) Bancorp has submitted to Treasury a complete and accurate list of the SEOs and the twenty next most highly compensated employees for the current fiscal year, with the non-SEO ranked in descending order of level of annual compensation, and with the name, title, and employer of each SEO and most highly compensated employee identified; and

(xvi) I understand that a knowing and willful false or fraudulent statement made in connection with this certification may be punished by fine, imprisonment, or both. (See, for example 18 USC 1001).

March 15, 2012

/s/ Stephen W. Lilly  
Senior Vice President, Chief Financial Officer  
(Principal Financial and Accounting Officer)

# **SHAREHOLDER INFORMATION**

## **Board of Directors**

*Alan J. Hyatt*  
Chairman of the Board

*Melvin E. Meekins, Jr.*  
Vice Chairman of the Board

*Eric M. Keitz*  
Certified Public Accountant

*John A. Lamon, III*  
Senior Account Executive  
G&G Outfitters, Inc.

*Ronald P. Pennington*  
Retired investor

*T. Theodore Schultz*  
President Schultz and Co., Inc.  
Accounting and tax practice

*Albert W. Shields*  
Real Estate Investor and  
Developer

*Konrad M. Wayson*  
Secretary and Treasurer  
Hopkins and Wayson, Inc.

## **Investor Relations**

Thomas G. Bevivino  
Severn Bancorp, Inc.  
200 Westgate Circle, Suite 200  
Annapolis, MD 21401  
Phone: (410) 260-2000  
tbevivino@severnbank.com

## **Corporate Officers**

*Alan J. Hyatt*  
President and  
Chief Executive Officer

*Thomas G. Bevivino*  
Executive Vice President,  
Chief Operating Officer,  
Secretary and Treasurer

*Philip V. Jones, Jr.*  
Executive Vice President,  
Chief Relationship Officer

## **Corporate Headquarters**

200 Westgate Circle, Suite 200  
Annapolis, MD 21401  
Phone: (410) 260-2000  
Toll free: (800) 752-5854  
Fax: (410) 841-6296

## **Internet Address**

[www.severnbank.com](http://www.severnbank.com)

## **Branch Locations**

*Annapolis Branch*  
1917 West Street  
Annapolis, MD 21401  
Phone: (410) 224-8800

### *Glen Burnie Branch*

413 Crain Highway, S.E.  
Glen Burnie, MD 21061  
Phone: (410) 768-6900

### *Edgewater Branch*

3083 Solomons Island Road  
Edgewater, MD 21037  
Phone: (410) 956-3700

### *Westgate Branch*

200 Westgate Circle, Suite 200  
Annapolis, MD 21401  
Phone: (410) 260-2100

## **Independent Auditor**

ParenteBeard LLC  
1869 Charter Lane  
Suite 301  
Lancaster, PA 17601

## **General Counsel**

Hyatt & Weber, P.A.  
200 Westgate Circle, Suite 500  
Annapolis, MD 21401

## **SEC Counsel**

Blank Rome LLP  
600 New Hampshire Ave., NW  
Washington, D.C. 20037

## **Stock Exchange Listing**

The common stock of Severn Bancorp, Inc. is traded on the Nasdaq Capital market under the symbol "SVBI"

## **Transfer Agent and Registrar**

*Registrar and Transfer  
Company*  
10 Commerce Drive  
Cranford, NJ 01016  
Attn: Investor Relations  
Phone: (800) 368-5948

## **Annual Meeting**

The Annual Meeting  
of stockholders will be held  
on April 24, 2012 at 9:00 A.M.  
at The Severn Bank Building  
200 Westgate Circle  
Annapolis, MD 21401

## This image shows a single sheet of white paper with horizontal blue or grey ruling lines. The lines are evenly spaced and run across the width of the page. There are approximately 20 lines visible. The paper appears to be a standard notebook page, possibly from a composition book or a legal pad. The edges of the paper are slightly irregular, suggesting it might be a scan of a physical document. There is no handwriting or other markings on the page.



# **Severn Bancorp, Inc.**

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*200 Westgate Circle, Suite 200  
Annapolis, MD 21401  
410-260-2000  
[www.severnbank.com](http://www.severnbank.com)*